CHAPTER 1

The Basics: Acquisition Methods and an Overview of the Process

Chapter Contents

§ 1.01 Overview of the Acquisition Process

This chapter will provide an overview of the acquisition process. Specifically, we will discuss many of the basic questions relating to the acquisition process. How does an acquisition get done? What are the steps in the process? What are the different ways of structuring a transaction? What does an acquisition agreement look like generally? What are its component parts? What are the parties' roles?

Threshold questions, of course, relate to the motivation and economics of any particular transaction. Why acquire this particular company? What price should be paid? Should the form of consideration be cash, common stock, preferred stock, short or long term debt securities, warrants or anything else? Does the purchase price need to be adjusted post-closing? Should there be an earn-out? These issues are often answered, at least within certain basic parameters, before the lawyers for either side become involved. However, the resolution of these questions can have significant corporate, tax and structuring implications and it is not at all unusual for any number of these basic decisions to be again examined once the lawyers are brought into the process.[1] The Authors will not deal with these economic questions,[2] except insofar as they affect legal, structuring or tax issues.

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[1] Price is often affected by legal issues. For example, consider the case where a buyer has agreed to a particular purchase price on the assumption that no environmental problems were being assumed. An inability to avoid potential liability for such matters (notwithstanding the availability of indemnification rights against a seller, see Chapter 15 *infra*) could result in the purchaser insisting upon a revised, lower purchase price. Similarly, in an acquisition in which the consideration is paid in preferred stock structured as a "reverse subsidiary" merger, the existence of voting rights in the terms of such stock could mean the difference between a taxable and a tax-free transaction. See § 3.02 *infra*.

[2] A voluminous literature has grown up around these issues. See, e.g.: Hopkins, *Mergers, Acquisitions, and Divestitures: A Guide to Their Impact for Investors and Directors* (1983); Scharf, *Acquisitions, Mergers, Sales and Takeovers: A Handbook with Forms*, 11-32, 49-71 (1971); *The Business of Acquisitions and Mergers* (Hutchinson ed. 1968); Harris, Determining the Right Price to Pay, contained in Lee and Colman, *Handbook of Mergers, Acquisitions and Buyouts* 149-69 (1981); Bangser, "Negotiations and Planning from Precontract through Closing," in Herz and Baller, *Strategies for Creating Economic Value Business Acquisitions* 1-30 (1981); Salter and Weinhold, *Diversification Through Acquisition* (1979) (contains extensive bibliography at 305-320). See also, Fox and Fox, 1 *Corporate Acquisitions and Mergers* 1-4 to 1-6 (1991)

§ 1.02 Acquisition Methods

If one corporation ("P") wishes to acquire the business of another[1] ("T"), there are essentially three different methods which could be used:

(1) a stock purchase;
(2) an asset purchase; and
(3) a merger under state law.[2]

It makes no difference whether T is a subsidiary of another corporation, privately owned by individuals, trusts or other entities, or a public corporation;[3] any of the three methods may be used. Similarly, it makes no difference whether the purchase price is payable in cash, common or preferred stock, debentures, notes, bonds, warrants or other property.[4] Moreover, virtually the same contractual representations and warranties, covenants, conditions and indemnities can be built into any of the three methods.[5]

[1]—Stock Purchases

In many respects, the stock purchase is the simplest method of acquisition. P purchases the stock of T from its shareholders. Each shareholder makes its own decision whether or not to sell. The acquisition agreement is a stock purchase agreement between P and the shareholders of T; there may be a different agreement with each

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[1] The three methods discussed in the text are also applicable to the acquisition of partnerships and limited liability companies. See § 1.02[9] *infra*.

[2] There are very important variations on the merger alternative, namely subsidiary mergers, discussed in § 1.02[4] *infra*, whereby P acquires T's business by means of a merger of T with a subsidiary of P. In addition, there are two other methods available in many but not all jurisdictions: a "consolidation" of P and T to form a new corporation, see § 1.02[3], N. 17 *infra*, and a "binding share exchange" of P and T, see: N.Y. Bus. Corp. L. § 913; Model Bus. Corp. Act § 11.03 (2008) and § 1.02[5] *infra*.

In § 1.03 *infra* we set forth a schematic analysis and comparison of the different acquisition methods discussed below.

[3] As a practical matter, however, a publicly owned company is never completely acquired by means of a stock purchase (which is, essentially, what a public tender offer is, see N. 6 *infra*) and the merger alternative (or a binding share exchange, if permitted under applicable law) is generally employed, at a minimum, as a final step in the process. See § 16.02 *infra*.

[4] There may, of course, be very different consequences that arise from the use of one method rather than another. See: Chapters 2 and 3 *infra*.

[5] See: § 1.05 and Chapters 11-15 *infra*. However, different norms concerning the governing agreement (particularly the breadth of the representations and warranties) have arisen in different types of transactions, particularly public company mergers where such agreements are often more "bare bones." See § 16.02 *infra*.

shareholder, one agreement signed by all of the T shareholders or anything in between.[6] Indeed, a purchaser can acquire less than the entire equity interest in T by not purchasing all of the outstanding T stock.[7] T may, but need not, itself be a party to the agreement.[8] T will continue in existence as a corporation following the acquisition as a subsidiary of P, wholly owned if all of its stock were acquired. T's shareholders will directly receive the purchase price, be it cash, securities or other property, from P.

[2]—Asset Purchases

Instead of acquiring the outstanding stock of T, P could acquire the business conducted by T by purchasing all of T's assets and assuming all of its liabilities and obligations.[9] Again, T continues in existence as a corporation. However, the situation is different from the purchase of stock of T discussed above in two important respects. First, T is still owned by its prior shareholders; it has not become a subsidiary of P. Similarly, P now owns, directly, what had formerly been T's assets, and P is now responsible for the liabilities and obligations of

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[6] The public tender offer is essentially a stock purchase agreement between the offeror and each of the tendering shareholders. Specifically, the execution of each letter of transmittal (or, depending upon the exact language of the tender offer, the offeror's acceptance of a duly executed letter of transmittal), constitutes a binding stock purchase agreement subject to the terms and conditions set forth in the offer to purchase and letter of transmittal.

At the other extreme from the public tender offer is the purchase of a subsidiary, usually accomplished by the purchase of stock from a single selling shareholder, the parent corporation.

[7] This can raise difficult fiduciary duty issues for selling control shareholders. See, e.g.:

Second Circuit: Perlman v. Feldmann, 219 F.2d 173 (2d Cir. 1955), *cert. denied* 349 U.S. 952 (1955) (applying Indiana law).

Third Circuit: Insuranshares Corp. v. Northern Fiscal Corp., 35 F. Supp. 22 (E.D. Pa. 1940).

State Courts:

California: Brown v. Halbert, 271 Cal. App.2d 252, 76 Cal. Rptr. 781 (1969).

See also, Clark, *Corporate Law* 478-498 (1986). See generally, § 4.11 *infra*. After consummation, it will also result in P (as T's majority shareholder) having certain fiduciary obligations to the remaining T shareholders. See, e.g.: Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983); Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971); Cary and Eisenberg, *Cases and Materials on Corporations* 613-638, 683-712 (1980).

[8] To the extend the agreement obligates T directly to take or refrain from taking any actions, T should be a party. The alternative, in all likelihood not as desirable from the purchaser's point of view, would be to obligate the shareholders of T to cause T to take or refrain from taking such actions.

[9] However, as a contractual matter, P need not agree to assume all, or any, of T's liabilities. This may or may not be effective as a matter of law. See § 18.07 *infra*.

T assumed by it.[10] T, by contrast, no longer holds what had been its assets or (to the extent P has agreed to take them) its liabilities (although, absent third party releases, T generally will remain liable for its obligations, with rights against P if it fails to discharge them). Second, the purchase price has been paid to T, not the shareholders of T. If these shareholders wish to receive such cash amounts or other property, they will have to liquidate T, have T declare a dividend on its outstanding stock or obtain such consideration in some other manner.

[3]—Mergers

Mergers are creatures of state corporate law. Unlike purchases of stock or assets, the ability of two companies to merge is solely a function of a statutory enabling provision.[11]

A merger of T into P results, as a matter of statutory definition, in P automatically succeeding to all of T's assets and all of T's liabilities.[12]

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[10] This description is necessarily short-handed. The conveyance of assets (particularly intangible assets such as contract rights) and liabilities often presents significant legal questions, including issues relating to third party consents. See § 2.08[2] *infra*.

[11] See, e.g.:

California: Cal. Corp. Code § 1100.
Delaware: 8 Del. Code Ann. § 251.
Florida: Fla. Stat. Ann. § 607.1101.
Illinois: Ill. Ann. Stat. Ch. 32, § 11.05.
Maryland: Md. Corps. & Ass'ns Code Ann. § 3-102.
Massachusetts: Mass. Gen. L. Ann., Ch. 156B, § 78.
Michigan: Mich. Comp. L. Ann. § 450.1701.
New Jersey: N.J. Stat. Ann. § 14A:10-1.
New York: N.Y. Bus. Corp. L. § 901.
Ohio: Ohio Rev. Code Ann. § 1701.78.
Pennsylvania: 15 Pa. Cons. Stat. Ann. § 1921.
Texas: Tex. Bus. Corp. Act Ann. Art 5.01.
See also, Model Bus. Corp. Act § 11.02 (2008).

The states whose laws are to be considered are the states in which the two constituent corporations are incorporated. Differences exist in some states when the merger is of a "foreign" (outside of the state) corporation with a domestic corporation rather than a merger of two domestic corporations. A number of states also do not provide for mergers of domestic corporations with entities organized outside the United States. See, e.g., 8 Del. Code Ann. § 252(a). Most states now permit mergers between entities of different types. See, e.g.: 6 Del. Code Ann. § 18-209, 8 Del. Code Ann. 264 (corporations and limited liability companies), and 6 Del. Code § 17-211, 8 Del. Code Ann. § 263 (corporations and limited partnerships).

[12] Stated slightly differently, the surviving corporation will have all of the rights and obligations, following the merger, of itself and of the disappearing corporation. See, e.g.:

California: Ca. Corp. Code § 1107.
Delaware: 8 Del. Code Ann. § 259(a).
Florida: Fla. Stat. Ann. § 607.1106.
Illinois: Ill. Ann. Stat., Ch. 32, ¶ 11.50.

Thus, at the *corporate* level, a merger is similar to a sale of all the assets of T to P and assumption of all of T's liabilities by P. The only difference in legal effect[13] is that, in the latter case, T remains in existence, still owned by its former shareholders; by contrast, in a merger, again as a result of the applicable corporate statute, T disappears. T simply goes out of existence or, perhaps more accurately, disappears into P.[14] From the viewpoint of the shareholders of T, however, the merger operates more like a stock purchase in which they all participate (except to the extent any such shareholder exercises in the merger any available dissenters' appraisal rights).[15] The T stock held by the T shareholders is converted in the merger, again as a result of the operation of the applicable state statute, into the consideration to be paid by P in the transaction. This consideration could under the law of most, if not all, states be securities, including stock, of P (or of any other entity), cash or other property.[16] The two companies

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Maryland: Md. Corps. & Ass'ns Code Ann. § 3-114.

Massachusetts: Mass. Gen. L. Ann., Ch. 156B, § 80.

Michigan: Mich. Comp. L. § 450.1724.

New Jersey: N.J. Stat. Ann. § 14A:10-6.

New York: N.Y. Bus. Corp. L. § 906.

Ohio: Ohio Rev. Code Ann. § 1701.82.

Pennsylvania: 15 Pa. Cons. Stat. Ann. § 1929.

Texas: Tex. Bus. Corp. Act Ann., Art. 5.06.

See also, Model Bus. Corp. Act § 11.07(a)(3), (4) (2009 revisions).

This is subject, however, to any provisions in contracts of either company which state that they terminate upon consummation of such a merger. See § 2.08[2] *infra*.

13 A "total" assumption of T's liabilities by P, and release of T, in an asset purchase is often not workable as a legal matter because of legal issues concerning the assumption of liabilities such as the existence of certain types of liabilities which, as a practical matter, cannot be fully avoided (e.g., tax or some environmental liabilities). See § 18.07 *infra*. Given how many liabilities most companies have, attempting to obtain releases from all persons to whom such liabilities have been incurred would be highly impractical.

14 Note that this distinction is eliminated if, following the transfer by T of all of its assets and liabilities to P in an asset transaction, T were to dissolve. In part for this reason, certain asset sales have been treated by courts as "de facto" mergers. See § 4.10 *infra*.

15 These are rights available to shareholders of companies involved in mergers (and in some jurisdictions in sales of all or substantially all of their assets) under various circumstances to be paid the "fair value" of their shares in lieu of the merger consideration. See § 2.06 *infra*.

16 Traditionally, state corporate law only permitted stock of P to be issued in mergers. This, however, is no longer the case. See, e.g.:

California: Ca. Corp. Code § 1101(d) (subject to certain limitations contained in § 1101).

Delaware: 8 Del. Code Ann. § 251(b)(5).

New York: N.Y. Bus. Corp. L. § 902(a)(3).

See also, Model Bus. Corp. Act § 11.02(c)(3) (2008).

See generally: Schulman and Schenk, "Shareholders' Voting and Appraisal Rights in Corporate Acquisition Transactions," 38 Bus. Law. 1529, 1537-1538 (1983); Note, merging, often referred to as the "constituent corporations," are both parties to the acquisition agreement. Sometimes (particularly in a three-party subsidiary merger transaction discussed below) the acquiring parent will also be a party to the agreement.[17] One important, but often overlooked, consequence of a merger, whether direct or a forward or reverse subsidiary (see below), is that target corporation shareholders lose their standing to bring derivative actions on behalf of the target,[17.1] absent the merger being fraudulently designed solely to eliminate target shareholder standing.

[4]—Three-Party Mergers

Two critical variations on the direct merger transaction have arisen as a result of other changes in state corporate law allowing securities of the parent of one of the constituent corporations or other property to be issued in a merger,[18] and of the potential for such transactions to be effected on a tax-free basis;[19] the forward subsidiary merger and the reverse subsidiary merger.

A forward subsidiary merger is a simple variation on the direct merger. Rather than merging into P as in a direct merger, T merges into S, a wholly owned subsidiary of P.[20] S succeeds to all of T's assets and liabilities, T goes out of existence and the T stock formerly held by T's shareholders is converted into the acquisition purchase price (cash, securities or other property)—the same consideration which the T shareholders would have obtained pursuant to a merger of T directly into P; the only structural difference between a direct and a forward subsidiary merger (although an important one) is that,

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"Three-Party Mergers: The Fourth Form of Corporate Acquisition," 57 Va. L. Rev. 1242 (1971).

[17] Most states also permit a "consolidation" of two (or more) corporations to form a new, third corporation. See, e.g., 8 Del. Code Ann. § 251(a). The separate existence of the two corporations ceases, and the new corporation succeeds to all of the assets and liabilities of each of them. See 8 Del. Code § 259(a). There is rarely any reason to consolidate two companies rather than merge one into the other. Indeed, the disadvantages associated with direct mergers (and forward subsidiary mergers), see § 2.08 *infra*, are in effect doubled in a consolidation—they now apply with respect to both disappearing corporations. As a result, consolidations are used very infrequently. Indeed, they are no longer permitted under the Model Revised Business Corporation Act. See, e.g., Model Rev. Bus. Corp. Act, Ch. 11, Introductory Comment (1991 ed.).

[17.1] See, e.g.: Lewis v. Ward, 852 A.2d 896 (Del. 2004); Lewis v. Anderson, 477 A.2d 1040 (Del. 1984); In re Countrywide Corp. Shareholders Litigation, 2009 WL 846019 (Del. Ch. March 31, 2009).

[18] See N. 16 *supra*.

[19] See § 3.03 *infra*.

[20] Generally S (both prior to, and, as the surviving corporation in, the merger) will have only one class of capital stock. This is also usually the case in the reverse subsidiary merger discussed below.

following consummation, the assets and, particularly, the liabilities of T have been assumed by a subsidiary of P, not P itself.

If a forward subsidiary merger is similar at the corporate level to an asset acquisition by P's subsidiary S, and at the shareholder level to a stock sale, a reverse subsidiary merger is similar in end result, from

(Text continued on page 1-9)

both the corporate and shareholder viewpoints, to a stock purchase of T by P. In a reverse subsidiary merger, S merges into T (S, rather than T, ceasing to exist) and T succeeds to all of S's assets and liabilities. If, as is often the case, S were a newly created shell corporation with no assets or liabilities, T, post-merger, would be the same entity, practically as well as legally, as T, pre-merger. Pursuant to the merger, the outstanding shares of common stock of S would be converted[21] into shares of common stock of T and, as a result, T would become a (wholly owned) subsidiary of P. The T stock held by the former shareholders of T is converted, by operation of the merger, into the acquisition consideration. The effect is the same as a purchase by P of all of the outstanding stock of T from its shareholders.

[5]—Binding Share Exchanges

A relatively recent acquisition method under some corporate statutes is the "binding share exchange." While not recognized in Delaware and many other jurisdictions, this form of acquisition is permitted in a growing number of states including New York.[22] The binding share exchange combines the advantages of a stock purchase with a reverse subsidiary merger. Pursuant to a plan of exchange, all of the outstanding shares of the target company, T, are exchanged for cash, stock or securities of the acquiror, P, or any other consideration, and P acquires all of the outstanding shares of T formerly owned by its shareholders. It is essentially a stock purchase which, upon receipt of the requisite board and shareholder approval, is binding upon all shareholders of T. The resulting structure is similar to a reverse subsidiary merger of T with a subsidiary of P;[23] however, a binding share exchange has the advantage of not constituting a "merger" for purposes of outstanding contractual provisions which prohibit T from being a party to a merger.[24]

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[21] Usually on a one-to-one basis.

[22] N.Y. Bus. Corp. L. § 913. See also, e.g.:

Maryland: Md. Corps. & Ass'ns Code §§ 3-105, 1-101(r-1).

Pennsylvania: 15 Pa. Cons. Stat. Ann. § 1931.

See also, Model Bus. Corp. Act § 11.03 (2008).

[23] Indeed, the New York statute provides that a binding share exchange has the same effect as merger insofar as convertible securities are concerned. See N.Y. Bus. Corp. L. § 913(i)(2). Query whether this is intended to be a merger in which the subject company is the survivor. *Cf.*, N.Y. Bus. Corp. L. § 913(i)(3).

[24] See § 2.08[2] *infra*. There is a question, of course, as to whether a third party to such a contract will be able to convince a court that it should interpret such language to cover binding share exchanges, as well as mergers.

[6]—Short-Form Mergers

An important special case of the merger of T into P is the situation where T is entirely, or almost entirely, owned by P. The primary effect of such a transaction is to eliminate the interest of the remaining minority shareholders in T by converting their stock into cash, securities of P or securities (other than common stock) of T. In order to effect this transaction, the state corporate statutes that provide for mergers generally may require, among other things, the approval of the board and shareholders of T, the board of P and, in certain circumstances, depending upon applicable state law, the shareholders of P.[25]

In order to streamline the procedures applicable to those transactions where there is no or only a small minority interest in T not owned by P, states have adopted so called "short-form" merger statutes. These provisions generally allow mergers to be accomplished between parents and subsidiaries without the approval of the board of directors[26] or a vote by shareholders of the subsidiary being acquired, thereby greatly simplifying and shortening the merger process, if:

(1) the parent owned at least a specified percentage[27] of the outstanding shares of each class of stock or voting stock of the subsidiary; and

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[25] See § 2.03[2] *infra*. There are disclosure requirements applicable to short-form mergers, at least for companies incorporated in Delaware, whether or not the target is publicly held. See Erickson v. Centennial Beauregard Cellular L.L.C., 2003 WL 1878583 (Del. Ch. 2003). See generally, § 16.02[5] N. 89.1 *infra*.

[26] California does require subsidiary board approval unless it was wholly owned. Cal. Corp. Code § 1110(b).

[27] The percentage is usually 90%, but varies from state to state. See, e.g.:

California: Cal. Corp. Code § 1110 (90%).

Delaware: 8 Del. Code Ann. § 253(a) (90% of the shares that would be entitled to vote on the merger). Preferred stock, which, under a company's charter, had "no voting rights," but had a "right of approval and consent" on a merger did not hold "voting stock" for purposes of the Delaware short form merger statute; rather it had a "vote on consent to the merger but not on the merger itself. See Matulich v. Aegis Communications Group, Inc. 2007 WL 1662667 (Del. Ch. May 31, 2007), *aff'd* 942 A2.d 596 (Del. 2008). While this result seems a little dubious to us, it does appear clear that having a contractual approval right, conferred, for example, in a stock purchase agreement, but not contained in a charter or a certificate of designation, will certainly not save a class of stock from being treated as non-voting for the purpose.

Illinois: Ill. Rev. Stat. Ch. 32, § 11.30 (90%).

New York: N.Y. Bus. Corp. L. § 905(a) (90%).

See also, Model Bus. Corp. Act § 11.05(a) (2009 revisions) (90%) (The Model Act, § 11.04 (1991), previously required a thirty-day wait between delivery of notice of the merger to the subsidiary shareholders and consummation of the merger. This was eliminated in 1999. See Model Bus. Corp. Act. § 11.05 (Annotation—Historical Background).).

(2) the parent board of directors adopts a resolution approving the merger.

Parent shareholder approval is generally not required.[28] In most jurisdictions, P can merge into T,[29] as well as having T merge into P; moreover, in some jurisdictions P can have T merge with another subsidiary of P.[29.1]

Just as subsidiaries could be used in traditional mergers to avoid combining the businesses of P and T within one entity, they can be used in conjunction with the short-form merger provisions. The first step is for P to transfer its T stock to a newly created wholly owned subsidiary, S, of P. Alternatively, P can cause S, rather than itself, to purchase the T stock in the first instance. S, which is now the parent of T, either causes T to merge into it, in effect a "short-form forward subsidiary merger," or, if permitted by the relevant jurisdiction, S mergers into T, a "short-form reverse subsidiary merger."

[7]—Reversing the Structure

It sometimes makes sense to reverse the roles of the purchaser and target in a common stock acquisition of an entire business and achieve the same economic result by having the target acquire the purchaser. This can be accomplished even if the target is much smaller than the purchaser. There are numerous reasons why this might make sense in any given transaction including, among others, avoiding a high shareholder vote requirement in the target's jurisdiction of incorporation or appraisal rights for target shareholders, dealing with a hold-out shareholder or not violating a provision in a contract of the target that

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[28] One exception to this is in a short-form stock merger where the parent's charter must be amended to obtain sufficient authorized, but unissued, stock to consummate the transaction.

[29] See, e.g.:

California: Cal. Corp. Code § 1110(a).

Delaware: 8 Del. Code Ann. § 253(a).

New York: N.Y. Bus. Corp. L. § 905(a).

See also, Model Bus. Corp. Act § 11.05(a) (2009 revisions).

In such a transaction, parent shareholder approval is generally required. See, e.g.:

California: Cal. Corp. Code §§ 1110(c), 1201(d).

Delaware: 8 Del. Code Ann. § 253(a).

See also: Model Bus. Corp. Act §§ 11.04, 11.05(a) (2009) (Official Comment).

Such "downstream" short-form mergers are not permitted under certain state corporate statutes. See:

North Dakota: N.D. Cent. Code § 10-19.1-100.

[29.1] This is not available in Delaware: 8 Del. Code Ann. § 253(a). See also, Model Bus. Corp. Act § 11.05(a) (1999).

prohibits it from being a party to a merger or transferring assets.[30] There may also be significant tax reasons for doing this.[31]

In such a transaction, shares of stock of the actual acquiror, P (the nominal target), will be converted into (or exchanged for in a stock sale or upon liquidation following an asset sale) a majority of the outstanding shares of the nominal acquiror, T (the actual target). An example in the case of a merger will illustrate the point. Suppose there are 800,000 shares of P common stock and 100,000 shares of T common stock outstanding and that P wishes to acquire T by issuing in the acquisition 2 shares of P common stock for each outstanding share of T common stock. A simple and straightforward transaction would be a merger of T into P, with the T shareholders receiving an aggregate of 200,000 shares of P common stock, representing 20% of the aggregate amount of P stock outstanding after the merger. The shares of P common stock owned by the P shareholders would remain outstanding, unaffected by the merger. Thus, the stock held by the continuing P shareholders would represent 80% of the P stock outstanding after the transaction. Suppose it were decided for one of the reasons discussed above to have T survive the transaction as the "acquiror" and, accordingly, to merge P into a subsidiary of T. Each share of T stock would remain outstanding after the transaction; the total number of shares of P stock would be converted pursuant to the merger into an aggregate of 400,000 shares of T stock, or 0.5 of a share of T stock for each share of P stock held. Again, the surviving corporation would be owned 20% by the persons who had previously been T shareholders and 80% by those who had previously been P shareholders. Consequently, the ownership of T in this second transaction is the same as that of P in the first. Moreover, T owns and conducts, directly or indirectly through its subsidiary, following the

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[30] The reasons why reversing the transaction might solve a problem such as those outlined above will vary depending upon the specifics of the transaction. For example, a target's shareholders would often be entitled under the laws of its jurisdiction of incorporation to a vote and, possibly, appraisal rights in respect of a merger of the target into an acquiror. Structuring the transaction as an acquisition by the target of the acquiror through a subsidiary merger might avoid these requirements. Of course, doing this might result in the acquiror's shareholders having voting or appraisal rights which they would not otherwise have. This will be a function, however, of the law of the jurisdiction of incorporation of the acquiror which may have different voting requirements or exceptions to the availability of appraisal rights than that of the target. In addition, even if the requirements in the acquiror's jurisdiction of incorporation are as or more stringent than those of the target's jurisdiction of incorporation, they may be more easily satisfied simply because the acquiror's shareholders are more enthused about the transaction than the target's. See Chapter 2 *infra*.

[31] See Chapter 3 *infra*.

second transaction the same business as P conducted following consummation of the merger in the first transaction. T can change its name to that of P. In many respects, the transactions are equivalent.[32]

Had the transaction been initially structured as a stock purchase by P from the T shareholders in exchange for P stock, reversing the form would simply require T to issue to the P shareholders a substantial amount of T stock in exchange for their P stock. P would become a wholly-owned subsidiary of T, rather than the reverse. Similarly, asset transactions can also be reversed. Instead of T selling its assets and liabilities to P for P stock which T then distributes in liquidation to its shareholders, P sells its assets and liabilities to T for T stock which, upon the liquidation of P, is distributed to P shareholders in exchange for their P stock. Unlike the case of the stock transaction or a subsidiary merger, the resulting corporate structure is the same regardless of the direction of the transaction; one entity, be it P or T, owns all of the assets, and is subject to all of the liabilities, of both companies.

It should be noted, however, that reversing the structure is often not doable if the acquisition consideration consists of cash or securities other than common stock.

[8]—Some Variations

[a]—Mergers of Equals

If two public companies, P and T, wish to combine in a stock-for-stock transaction—that is, one in which the resulting company is owned by its respective stockholders—a number of merger transaction structures are possible:

(1) P can merge into T,
(2) T can merge into P;
(3) P can merge into S, a subsidiary of T;
(4) S can merge into P, which becomes a subsidiary of T;
(5) T can merge into Q, a subsidiary of P;
(6) Q can merge into T, which becomes a subsidiary of P; and
(7) X and Y, subsidiaries of a new company, H, can merge into P and T, respectively, so P and T become subsidiaries of H.

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[32] The question of whether the transactions are identical in all important business respects is more complicated, the answer to which depends on such questions as who comprises the post-closing board of directors of P in the first structure and T in the second. See: §§ 1.08 and 22.01 *infra*.

In the first, third and fourth of these situations, the outstanding stock of P is converted in the merger into stock of T. In the seventh structure (referred to as a "double dummy"), the outstanding stock of P and T is converted in the two mergers into stock of H. In the others, the stock of T outstanding is converted into stock of P. As we saw in the preceding subsection, by adjusting the exchange ratio, the same transaction, with the same ownership split between the former shareholders of P and T, can be accomplished in any of these six ways. The appropriate choice in any given instance may be dictated by concerns such as those set forth below.[32.1]

However, in any given situation, subject to these more substantive considerations, there may from a purely optical or cosmetic sense be a "natural" choice—at least as between which company remains the publicly owned entity. For example, if one company is significantly larger than the other, absent unusual circumstances, that one will survive as the parent entity. Where the two companies are of roughly equal size, however, there may not be an obvious choice as to which would play this role. Indeed, once can imagine several different factors that might point to one or the other:[32.2] the entity whose shareholders will own in the aggregate the larger percentage of the combined companies; the company whose management will have the more senior positions in the combined company; or the company whose directors will represent a majority of the board of the combined company or the "history" of the transaction.[32.3] Indeed, the appearance of the transaction can have important consequences, notwithstanding the somewhat illogical nature of this. For example, if the two companies—P and T—have stock with different price-earnings ratios, a structure where the one with the higher ratio prior to the transaction remains as the publicly traded entity is arguably more likely to result in the post-closing entity having a higher ratio than one in which the lower multiple company's stock is used as the acquisition consideration. Another instance has to do with litigation brought against boards of directors for failure to comply with their fiduciary duties when selling the company or engaging in a strategic combination.[32.4] Such litigation often follows the structure, as absurd as this approach may seem. Thus, litigation may well be brought against the T board, but not that of P,

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[32.1] See § 1.02[11] *infra*.

[32.2] See § 22.01 *infra*.

[32.3] For example, if one company acted as the "white knight" for the other, it will generally not be cast as the company which becomes a subsidiary or is merged out of existence.

[32.4] See § 4.04 *infra*.

if T is merged with a subsidiary of P with T shareholders receiving P stock; however, if, by adjusting the exchange ratio, T had continued as the publicly held entity with P stockholders receiving T stock, the litigation might have been aimed at only the P directors. Varying the structure of the transaction may also lead to different results under various employee benefit plans of the constituent companies, particularly since many executive compensation agreements are triggered by "changes of control" of their employing entity.[32.5]

The double dummy structure, as an optical matter, appears the most neutral. It is also the most flexible in terms of the consideration that can be paid to shareholders without jeopardizing the tax-free status of the transaction.[32.6] This, however, may lead to a concern that the market could view the resulting company as not having a clear management hierarchy or direction.

[b]—Target Repurchase as Part of the Acquisition Structure

On occasion it may be advantageous for the acquisition to be structured as an acquisition of stock (either from an existing shareholder or of newly issued shares directly from the target) by the acquiror, coupled with a repurchase of some or all of its remaining shares outstanding by the target. If the target is public, the repurchase will be accomplished as an issuer tender offer. If fewer than all of the outstanding shares are repurchased, the transaction will leave outstanding some of the shares owned by the former target shareholders.[33] In this case the transaction arguably resembles a recapitalization[34] more closely than an acquisition, particularly if the acquiror purchases a small percentage of the issuer stock outstanding post-target repurchase, although even in this case control can be acquired. From a financing perspective, this is quite a simple structure. The debt financing is directly incurred by the target and the equity financing is provided by the acquiror. In addition, depending on the level of continuing ownership of the former target shares, this transaction might be accounted for as a recapitalization (i.e., a redemption of stock) rather than a purchase.[35]

[32.5] The costs may differ dramatically, especially if one of the companies' benefits provides for "gross-up" of income which would be taxable to an executive and the other company's plans do not so provide. See § 19.05[2] *infra*.

[32.6] See § 3.05[1] *infra*.

[33] In the case of a publicly held target, this will be the situation.

[34] See § 20.07 *infra*.

[35] See § 3.07[3] *infra*.

[9]—Acquisitions of Less than an Entire Company

Buyers do not always wish to acquire the entire business conducted by an entity. For example, T may operate several divisions and own several subsidiaries. P might wish to acquire only one or two of the divisions.[36] Alternatively, P might wish to acquire only certain assets and liabilities of such division, or all of the assets but none of the liabilities of the division. One way would be for T to transfer the assets to be sold, and the liabilities to be assumed, to a newly formed subsidiary, and sell the stock of the subsidiary to P or cause the subsidiary to merge with P or a subsidiary of P. A second method would be through an asset purchase; rather than purchasing all of T's assets and assuming all of T's liabilities, P would acquire only those assets and liabilities that it wants.[37]

The acquisition agreement would be between T and P (in the case of an asset sale by T or a sale by T of the stock of its newly organized, wholly owned subsidiary) or among T, P and T's newly created subsidiary if the transaction involved a merger of such subsidiary and P. In each case, T would receive the purchase price and continue in existence.

[10]—Acquisitions of Partnerships, Limited Partnerships, Limited Liability Partnerships and Limited Liability Companies

Just as acquisitions of corporations can be accomplished in different ways, so too can partnerships and limited liability companies be acquired using a number of differing techniques.

Asset sales by general partnerships, limited partnerships, limited liability partnerships[38] and limited liability companies are similar to the corporate model. Partnerships and limited liability companies have the ability to sell some or all of their assets;[39] purchasers may assume the sellers' liabilities. As in the corporate case, the selling

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[36] If P wished to acquire any of the subsidiaries, it could be accomplished by one of the methods discussed in § 1.02[1]-[4] *supra*, replacing references to T in the discussion by references to such subsidiary.

[37] There are instances where P will be unable to avoid liability to third parties for certain of T's liabilities. See § 18.07 *infra*. Conversely, the assumption by P of T's liabilities to third parties will not, in and of itself, result in T being released from such liabilities.

[38] In certain jurisdictions, limited liability partnerships are general partnerships. See California: 4-42A Ballantine and Sterling California Corporation Laws § 640 (2010).

[39] See, e.g.: Cal. Corp. Code §§ 17003(e), 17600(c).

entity remains in existence, continuing to own any retained assets and liabilities, as well as the purchase price.[40]

In an analog to stock transactions, partners can sell their partnership interests.[41] As in the corporate case, the partnership continues to own its assets, liabilities and business without change; it simply has a new owner.[42] The former partners directly receive the purchase price. Similarly, members of a limited liability company may transfer their membership interests,[43] with the limited liability company continuing to own its assets, liabilities and business without change.

The final method of acquisition of corporations, via merger, is also available in certain jurisdictions with respect to partnerships[44] and limited liability companies.[45] The statutes set forth the approval requirements,[46] the effects of the merger,[47] the requisite procedural steps which must be taken to effectuate the merger,[48] and, on occasion, provisions relating to the availability of appraisal rights.[49]

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40 The approval requirements of such a transaction are generally a function of the partnership or operating agreement.

41 Many limited partnership agreements require the general partner(s)' consent for the transfer by the limited partners of their interests. *Cf.*, Treas. Reg. § 301.7701-2(e).

42 For federal income tax purposes, however, a change in the ownership of more than 50% of the partnership interests in a twelve-month period can cause a termination of the partnership. See Internal Revenue Code of 1986, as amended, 26 U.S.C. § 708.

43 See: Cal. Corp. Code §§ 17300, 17301(a) (except as otherwise provided, members may assign their economic interests without consent, or may transfer their membership interests with the consent of a majority of the non-transferring members).

44 See, e.g.:

California: Cal. Rev. Ltd. Partnership Act § 15678.1 *et seq*. (merger of two or more limited partnerships); Cal. Corp. Code § 16910 (merger of partnership and other business entities).

Delaware: 8 Del. Code Ann. § 263(a); Del. Code Ann. § 17-211 (merger of limited partnerships with each other or a corporation).

45 See, e.g., California: Cal. Corp. Code § 17550 *et seq*.

46 See, e.g.:

California: Cal. Rev. Ltd. Partnership Act § 15678.2(a) (unless otherwise provided in the partnership agreement, approval is required by all general partners and a majority in interest of each class of limited partners); Cal. Corp. Code § 16911.

Delaware: Delaware 6 Del. Code Ann. § 17-211 (unless otherwise provided in partnership agreement, approval is required by all general partners and by holders of more than 50% in interest in profits of each class of limited partners).

47 See, e.g.:

California: Cal. Rev. Ltd. Partnership Act § 15678.6; Cal. Corp. Code § 16911.

Delaware: 6 Del. Code Ann. § 17-211(h).

48 See, e.g.:

California: Cal. Rev. Ltd. Partnership Act § 15678.2; Cal. Corp. Code § 16911.

Delaware: 6 Del. Code Ann. § 17-211(c).

49 See: Cal. Rev. Ltd. Partnership Act §15679.1 *et seq*.; Cal. Corp. Code § 17605(c).

[11]—Issues to Be Considered in the Different Structures

In connection with most, if not all, acquisitions the questions set forth below will arise. In some, they will not pose a problem; in others they could easily result in the parties' determining not to proceed with the transaction. *The critical fact, however, is that the answer to the question of whether any one of these potential problems will arise often will depend upon the structure of the transaction.* The purchase of a business by means of a merger might avoid issues that directly acquiring the assets and liabilities that comprise such business could give rise to; the converse may also be true. A reverse subsidiary merger might not be able to be done on a tax-free basis, whereas structuring the same transaction as an asset purchase or forward subsidiary merger might allow it to be. There are virtually a limitless number of possible situations, and each transaction has to be analyzed and structured based on its own particular facts.[50]

These questions, however, are almost always present:

(1) Is board of directors approval required of any part and, if so, which one or ones?

(2) Is shareholder approval required of any part and, if so, which one or ones? What is the required vote? Is there any separate vote required by any class or series of preferred stock?

(3) Will the transaction result in the recognition of federal income tax to any corporation or group of shareholders?

(4) Are there other federal income tax consequences of the transaction?

(5) Will the transaction result in the incurrence of transfer, use, property or other state or foreign taxes?

(6) Is the consent of, or notice to, third parties (such as lessors) required? Will the transaction breach any agreement or give lenders the right to accelerate any indebtedness?

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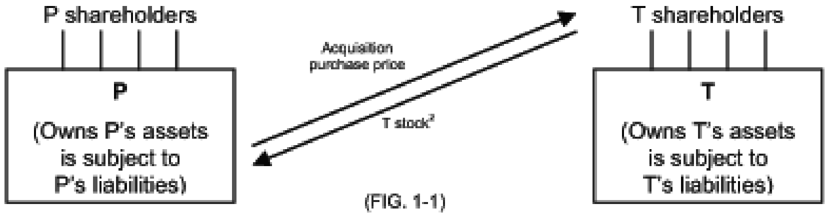
[50] See: Chapters 2 and 3 *infra* for a detailed analysis of the different structures with respect to the issues set forth in the text.

§ 1.03 Schematic Summary of Acquisition Methods

Set forth below is a schematic summary of certain[1] of the different acquisition methods discussed in § 1.02 *supra*.

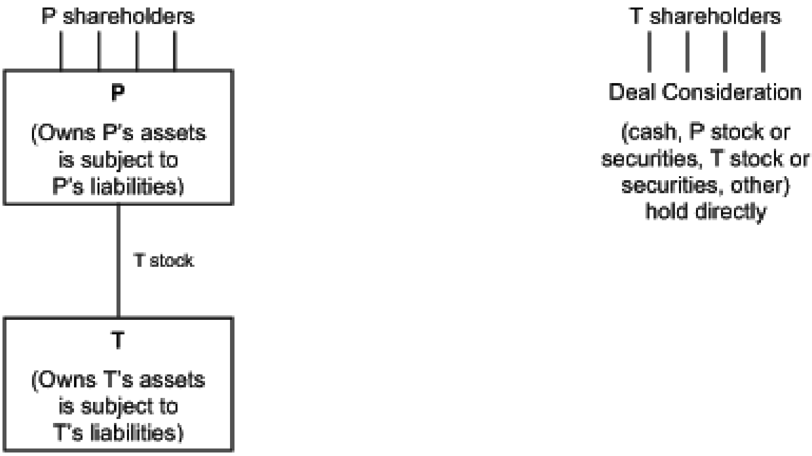
[1]—Stock Purchase

Transaction



(FIG. 1-1)

Result



(FIG. 1-2)

[NEXT PAGE IS 1-21]

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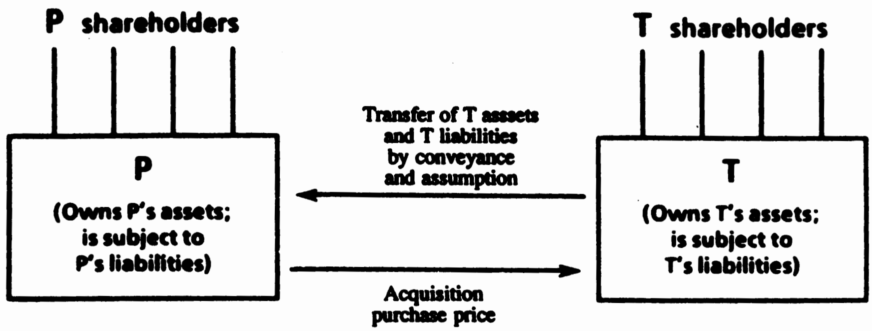
[1] Since a binding share exchange is identical to a stock purchase, we have not separately covered it.

[2] If the former shareholders are to retain a common stock interest in T, they do not sell all of their shares to P.

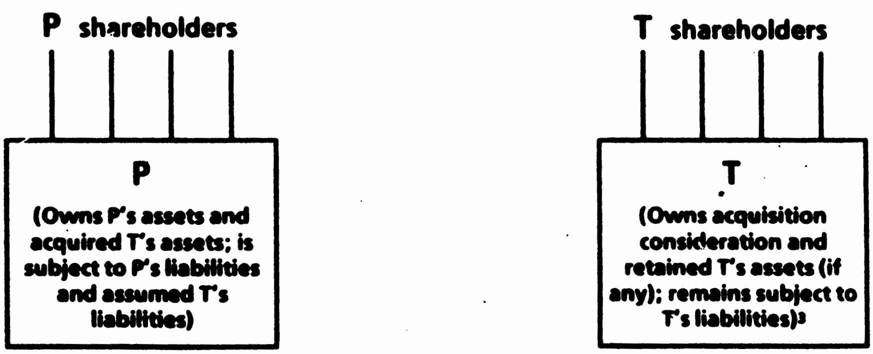
[2]—Asset Purchase

Transaction



(FIG. 2-1)

Result

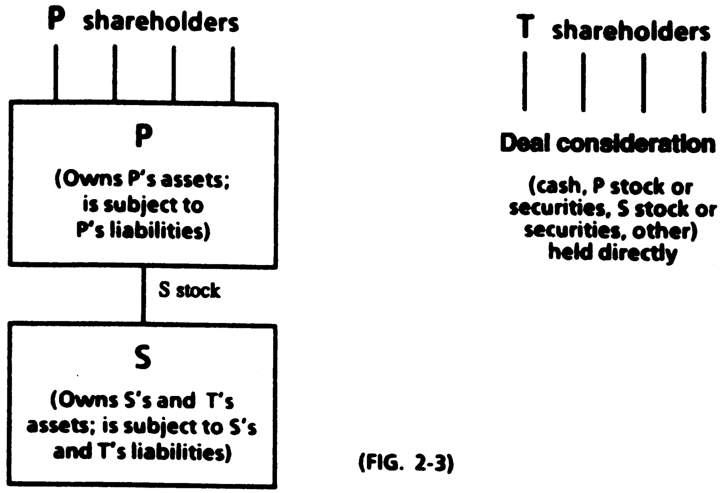


(FIG. 2-2)

[3] T generally will remain subject to T's liabilities to third parties even if all such liabilities were assumed by P unless such third parties discharged T from such liabilities (and assuming all of such liabilities were able to be so discharged); if T were even held liable in respect of any assumed liabilities; it may have a claim against P.

A variation on the asset purchase by P is worth noting: suppose that (1) S, a wholly owned subsidiary of P, acquires all of T's assets and assumes all of T's liabilities and (2) T distributes the merger consideration to its shareholders upon the liquidation of T[4]

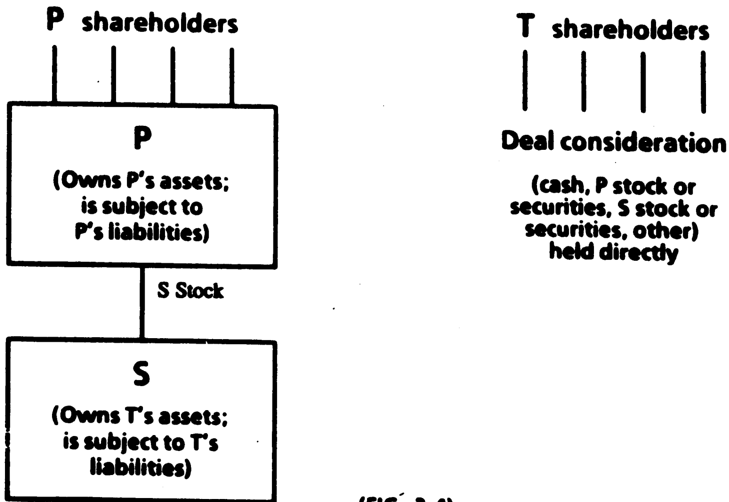
Result



(FIG. 2-3)

The result becomes simpler if S had no assets or liabilities immediately prior to the acquisition:

Result



(FIG. 2-4)

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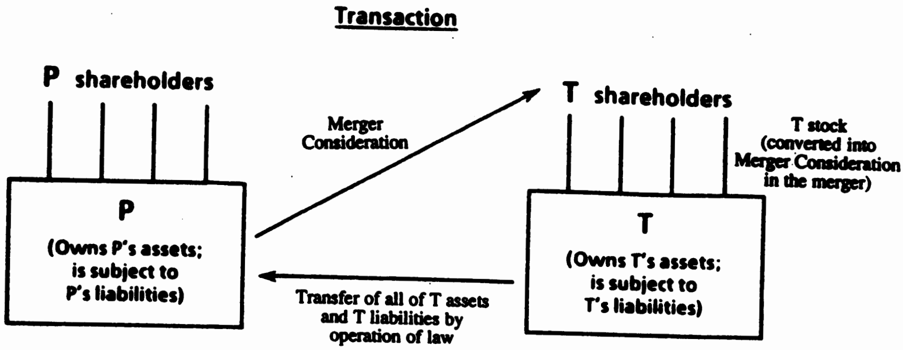
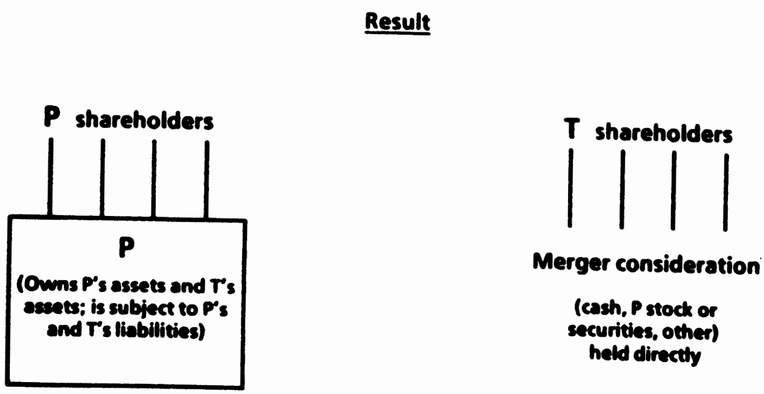
[4] This may require registration under the Securities Act of 1933 if the acquisition consideration consists, for example, of securities of P. Also, adequate reserves against non-discharged liabilities may need to be established before the liquidation of T occurs.

[3]—Parent/Target Merger



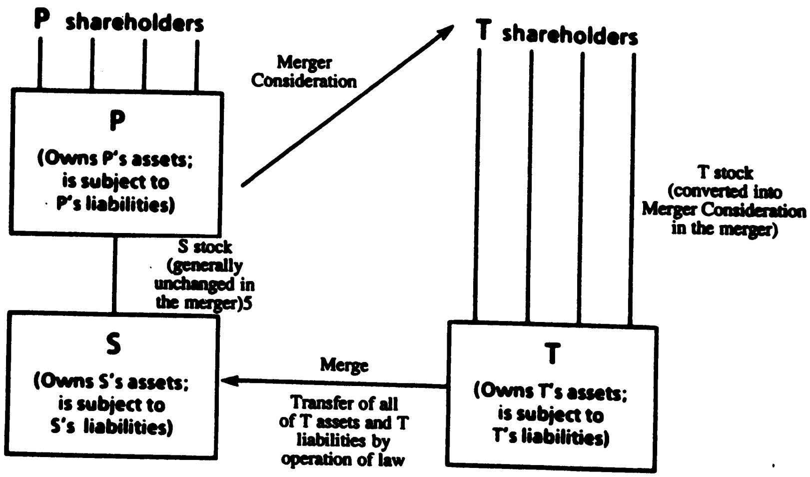
(FIG. 3-1)



(FIG. 3-2)

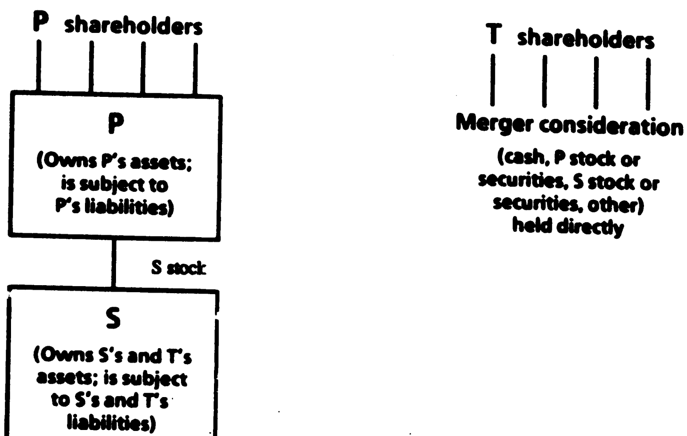
[4]—Forward Subsidiary Merger

Transaction



(FIG. 4-1)

Result



(FIG. 4-2)

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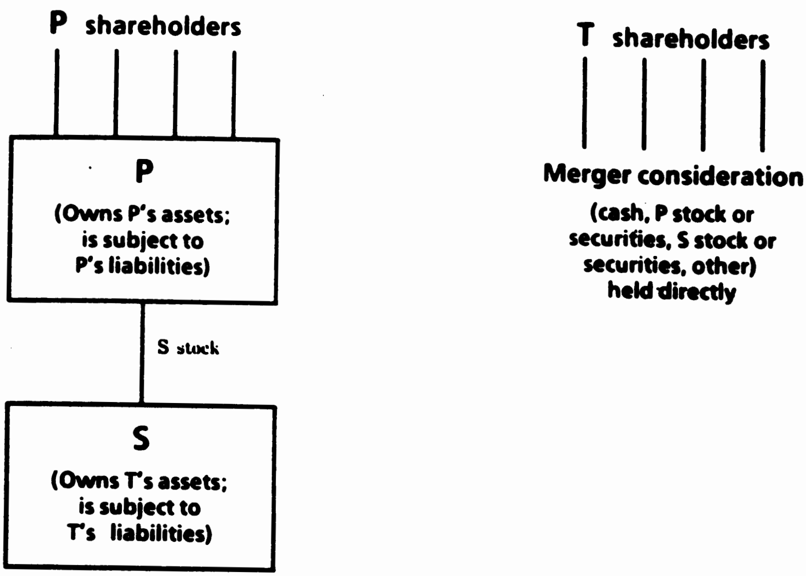
[5] In the unusual event where the former T shareholders are to obtain some common stock ownership in S following the merger, the S stock formerly held by P will normally be converted into a greater number of shares of stock, post merger, so as to represent the appropriate percentage interest in S held by P at such time.

If, as is often the case, S had no assets or liabilities of its own prior to the merger, then it would hold only the T assets and liabilities thereafter.

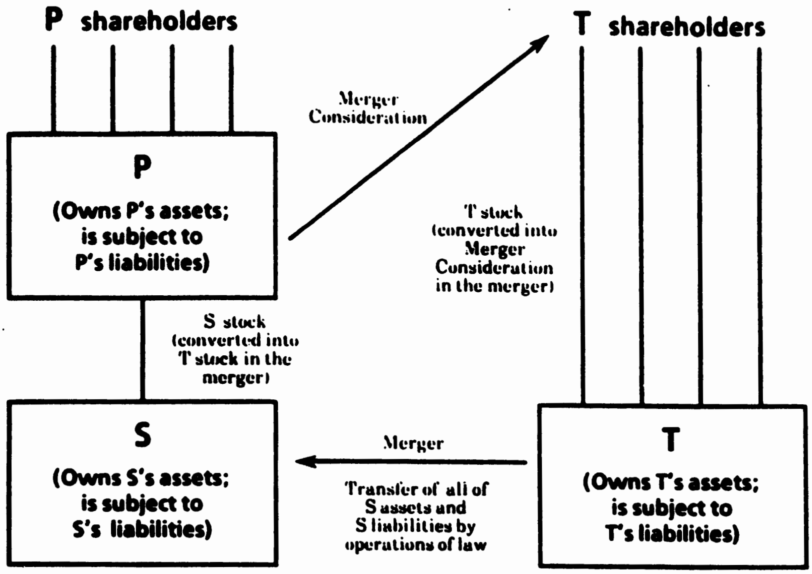
Result



(FIG. 4-3)

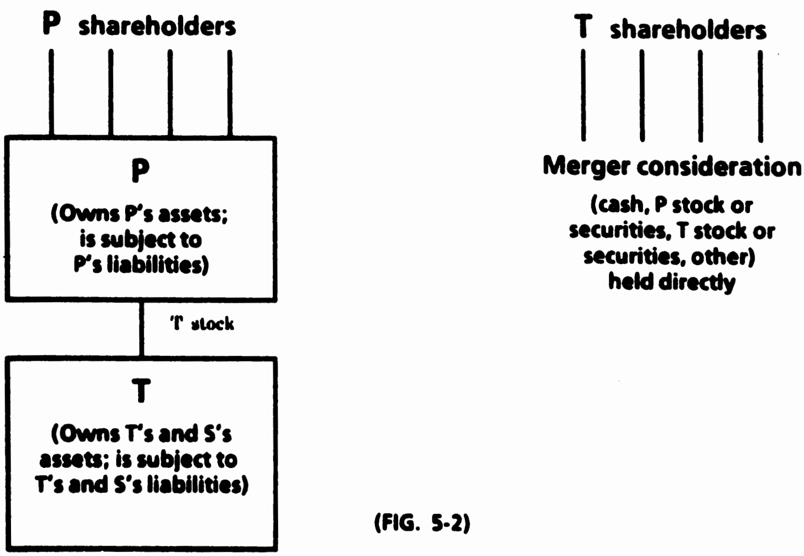
[5]—Reverse Subsidiary Merger

Transaction



(FIG. 5-1)

Result

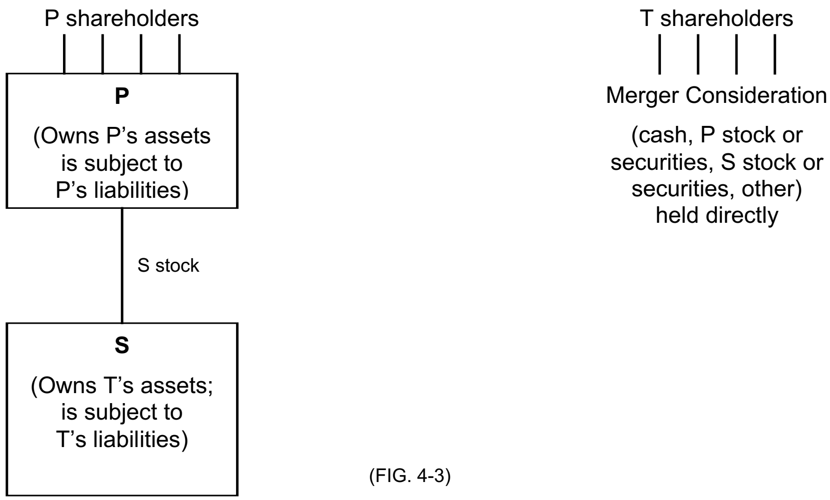


(FIG. 5-2)

(Text continued on page 1-25)

If, as is often the case, S had no assets or liabilities of its own prior to the merger, then it would hold only the T assets and liabilities thereafter.

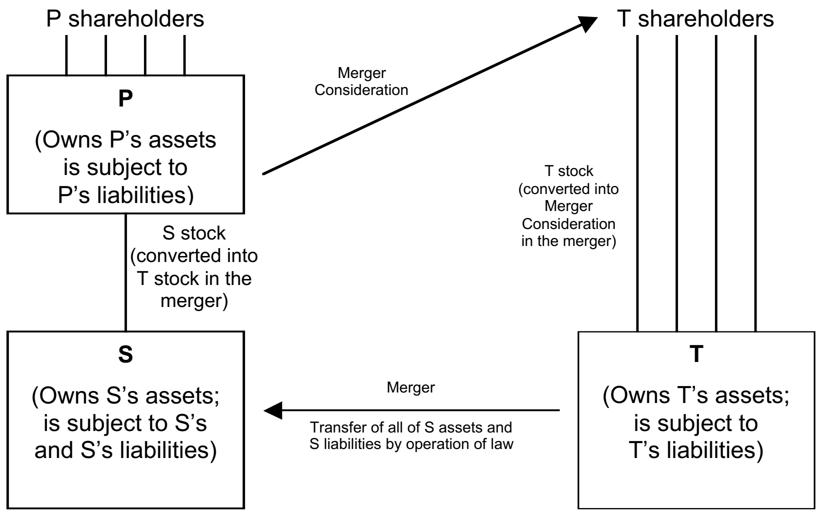
Result



(FIG. 4-3)

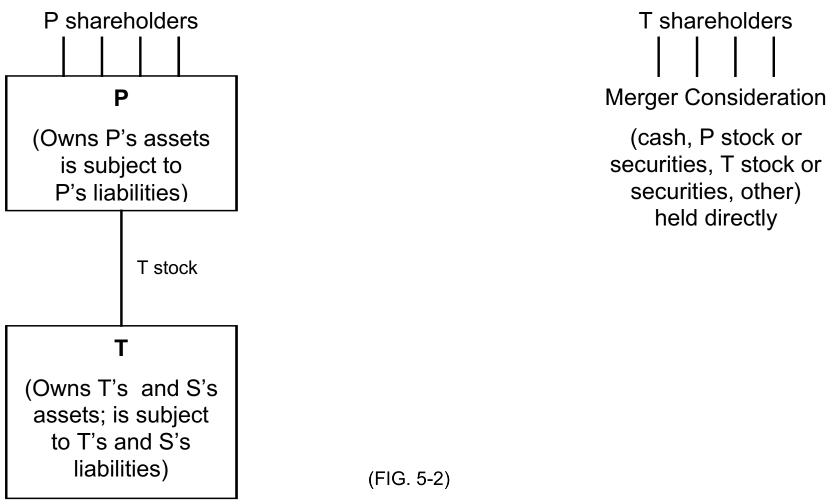
[5]—Reverse Subsidiary Merger

Transaction



(FIG. 5-1)

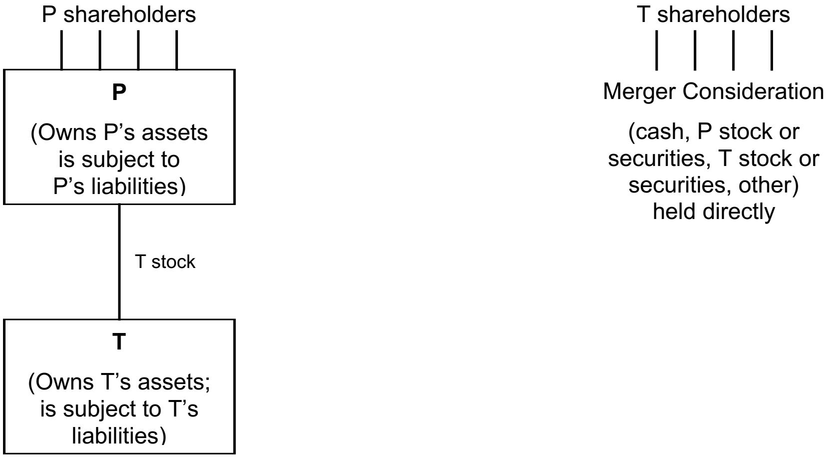
Result



(FIG. 5-2)

If S had no assets or liabilities of its own prior to the merger, then it would hold only the T assets and liabilities thereafter.

Result



(FIG. 5-3)

§ 1.04 The Acquisition Process

The general overall process that a buyer and seller or sellers and their lawyers and other advisors go through does not depend very much upon the structure of the acquisition nor vary from deal to deal. Of course, the specifics, particularly with respect to the question of shareholder approval, are generally dependent upon structure and may vary significantly and result in different time frames for the completion of the transaction, especially in the case of acquisitions of public companies.[1] With these caveats, however, the process is fairly standard.

The steps outlined below are fairly typical of many transactions in terms of "what happens when" and "who does what." Significant variations from this pattern can occur, however, oftentimes unexpectedly, in any particular transaction.

[1]—Sequence of Events

[a]—Initial Negotiations on Price and Terms; Letter of Intent

The first step in any acquisition is a realization by the parties that there may be a deal to be made. Sometimes investment bankers for one or both parties are involved at this stage; sometimes not. Lawyers are generally not involved at this phase except, perhaps, to have given some advice about the process to their clients or to have drafted or negotiated an appropriate confidentiality agreement.[2]

Many times a potential acquiror has determined that it is looking for an acquisition in a particular industry and has, by itself or with the help of its financial advisor, narrowed down the universe of potential targets to one or a few candidates. The buyer may be talking to one or several possible candidates at once. On other occasions, there will be only one company that whets its appetite. Conversely, the process may commence with the seller. Again, one or many potential buyers might be targeted initially; again, discussions might be conducted with one or several at a time.[3]

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[1] A very important example is the differences between a multi-step acquisition of a public company for cash with a tender offer as an initial step, and a traditional one step cash merger. See § 16.02 *infra*.

[2] Lawyers may have provided more services by this point in the transaction if the process being followed warranted it. For example, if the seller is conducting an auction, the bid package sent to prospective buyers early in the process will often include a draft acquisition agreement prepared by the seller's lawyer which each bidder is asked to return (together with requested revisions) to the seller or sellers with its bid. See § 22.06 *infra*.

[3] One recent trend is the use of auctions for all types of transactions including sales of public companies, as well as private companies and subsidiaries and divisions.

The parties usually commence their business and legal due diligence during this period.[4] The scope of the review at this initial stage will depend on a number of factors, including risk of leaks, concern over business disruption, time availability, conservatism of the parties, existence or imminence of a letter of intent and competitive sensitivities. For any one or more of these reasons, neither party may wish, even with a signed confidentiality agreement in place, to allow the other full access to itself and its employees at this early stage.[5]

These negotiations might, but need not, proceed to an agreement in principle, embodied in a letter of intent.[6] A letter of intent can be a document that is less than a page or one that is quite lengthy, almost as long as the acquisition agreement itself. There are both advantages and, particularly where the company to be acquired is publicly owned, disadvantages that flow from executing a letter of intent.[7] If a letter of intent is signed, there is usually a public announcement of the fact, at least where one of the companies is publicly held.[8]

Sellers believe that auctions provide the greatest likelihood of achieving the highest purchase price and significantly speeding up the negotiation process. However, in a marketplace where financing is difficult to obtain, auctions do not necessarily bring a high number of competing bids. Since there is nothing quite as bad for a seller than a property that has been "shopped" excessively and found no takers, in the current financing market the "targeted" buyer/seller approach is again gaining in popularity. The Authors believe, however, that auctions (perhaps with a more targeted format) will remain a popular technique, particularly with sellers responding to hostile tender offers. See § 22.06 *infra*..

[4] See Chapter 8 *infra*.

[5] See § 9.03 *infra*.

[6] See Chapter 6 *infra*.

[7] The advantages include memorializing the agreement between the parties and serving as a triggering event for Hart-Scott-Rodino Act filing purposes; the disadvantages include the time "wasted" if the parties begin a lengthy negotiation of a document (that is to be replaced by the acquisition agreement anyway) and the creation of a "liability" document. See:

Second Circuit: Arcadian Phosphates, Inc. v. Arcadian Corp., 884 F.2d 69 (2d Cir. 1989) (applying New York law).

State Courts:

Texas: Pennzoil Co. v. Texaco, Inc., No. 84-05905 (15 1st Dist. Harris County, Nov. 15, 1985), *aff'd* Texaco, Inc. v. Pennzoil Co., 729 S.W.2d 768 (Tex. App. 1987) (applying New York law).

See § 6.03[3] *infra*.

[8] Public disclosure may have been required prior to the execution of a letter of intent since the United States Supreme Court has held that preliminary merger negotiations may be material as a matter of law. See Basic, Inc. v. Levinson, 485 U.S. 224, 108 S.Ct. 978, 99 L.Ed.2d 194 (1988). See Chapter 7 *infra*.

[b]—Board Approval and Execution of the Acquisition Agreement

Whether or not a letter of intent has been executed, the next step in the acquisition process is the negotiation, approval and execution of an acquisition agreement. While the identity of the entities which actually enter into the acquisition agreement will depend upon whether the transaction is structured as a stock purchase rather than an asset purchase or merger, the negotiation process is similar. During the course of negotiating and finalizing the acquisition agreement, the parties will be continuing, and in most cases, essentially completing[9] their due diligence. In addition, if the price has not already been agreed upon[10] or a purchase price adjustment mechanism is needed, this negotiation is also occurring during this period. At a point when the agreement is fully negotiated, or almost finalized,[11] the parties will usually obtain the necessary board approvals,[11.1] including, in the

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[9] Due diligence investigations by the parties generally continue, although usually in a much less intensive manner, following the execution of the acquisition agreement. The purpose of these on-going analyses is often geared to the problem of post-closing integration of the two businesses (especially, in the context of acquisitions of public companies, integration relating to the ability of the combined company to comply with certain provisions of the Sarbanes-Oxley Act, including establishing a process of internal control over financial reporting and instituting appropriate disclosure controls and procedures). See § 5.10[2][b], [c] *infra*. Although an important additional effect of such investigation is to allow the parties to help determine their rights and obligations (e.g., ability to refuse to close based on a misrepresentation), it generally does not add to these rights and obligations. Hence, it is critical for the parties to be satisfied with the extent of their investigations at the time of signing the acquisition agreement. On relatively rare occasions, there will also be a due diligence closing condition. See § 14.10 *infra*.

[10] See Chapter 7 *infra*.

[11] This is not to say that the boards of directors of the parties will not have already had (possibly several) meetings to review and discuss the transaction including perhaps earlier drafts of the acquisition agreement. See: §§ 4.02, 4.03, *infra*. *Cf.*, Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

[11.1] Approval by a board of directors is usually reflected in formal resolutions that are adopted by the board authorizing particular actions that are required to enter into and consummate a transaction. Such resolutions may be adopted by either a vote of the directors or the execution of a written consent, depending on the company's charter and bylaws. For a troubling tale of the perils of a board of directors not properly authorizing a corporate action, consider the facts of *MobileToys, Inc. v. Fragiosa*, C.A. No. 19821 (Del. Ch. 2002). In an effort to raise capital, MobileToys, a small start-up company, issued two tranches of preferred stock to investors. The problem was that the board of directors adopted resolutions permitting the offering of five million shares of preferred stock when the certificate of incorporation only authorized *500,000* shares. After a dispute between the founders of the company, two former directors who sought to take control of the company seized upon this issue, and sought to take action by written consent of only the common stockholders, claiming that case of a stock purchase agreement, the boards of directors of the selling shareholders. Fairness opinions by financial advisors (if a part of the transaction) will typically be delivered at the board meeting at which the execution of the agreement is approved.[12]

Shortly following these board meetings, the parties would normally execute[12.1] the acquisition agreement, and immediately thereafter issue a press release if one were required by law or otherwise desired by the parties.[13]

[c]—The Period Pending Closing

[i]—The Main Timing Considerations: Federal Securities Laws and the Hart-Scott-Rodino Act

The parties have now signed the agreement and are waiting to close the transaction. The length of this time period will often primarily be a function of two factors: whether the filing requirements of the

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the preferred shareholders did not possess properly issued stock. The court agreed, basing its conclusion on the view that the issuance of capital stock requires "strict conformity with the statutory requirements" and, "to the extent that the stock is invalid, equitable claims . . . will not help a claimant seeking to vote or to validate the stock." *Id*. See also, STAAR Surgical Co. v. Waggoner, 588 A.2d 1130 (Del. 1991).

[12] See: §§ 14.08, 22.04 *infra*.

[12.1] One decision has enforced an agreement against a party that never executed it. See AIH Acquisition Corp. v. Alaska Industrial Hardware, 2003 WL 21511921 (S.D.N.Y. 2003), discussed at § 1.05 N. 1 *infra*.

[13] One potentially troublesome issue is the timing of the delivery of a disclosure document in the case of a stock purchase agreement where the acquisition consideration consists of stock or securities of the acquiror. Since "sale" is defined by Section 2(3) of the Securities Act of 1933 and Section 3(14) of the Securities Exchange Act of 1934, as amended, to include agreements for sale, securities law problems would arise if, as in the case of a merger, the parties wish to execute the acquisition agreement (i.e., the stock purchase agreement) first, and then deliver the acquiror's disclosure document to the selling shareholders. See Sections 2(3) and 5 of the Securities Act of 1933, 15 U.S.C. §§ 77b(3), 77e; Sections 3(14) and 10(b) of the Securities Exchange Act of 1934, as amended, 15 U.S.C. §§ 78c(14), 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. § 240. 10b-5. One might expect these issues to disappear if each selling shareholder has the right, in its sole discretion, to terminate the acquisition agreement as to itself after reviewing the disclosure document. Unfortunately, the above-referenced definitions of "sale" are broad enough to encompass agreements with significant closing conditions and termination rights. However, if the stock purchase agreement can be recharacterized as an agreement granting a put option to each selling shareholder, the statutory prohibitions might be avoided. The issue is most often resolved by having the parties' disclosure schedules delivered in draft form some period prior to the execution of the acquisition agreement, with the final disclosure schedules being delivered immediately prior to the execution of the agreement.

federal securities laws[14] apply to the transaction and whether the transaction is subject to the waiting period requirements of the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (the "Hart-Scott-Rodino Act").[15]

If the buyer is required to register securities under the Securities Act of 1933 or to qualify an indenture under the Trust Indenture Act of 1939, or the company being acquired has to file a proxy or consent statement with the SEC pursuant to the Securities Exchange Act of 1934, as amended, in connection with obtaining shareholder approval of the sale, the period between signing and closing could be substantial.[16] It could easily take up to twenty days or longer to prepare the registration statement or proxy statement to be filed with the SEC and an additional thirty to sixty days to complete the SEC review process and mail it to shareholders.[17]

If no SEC filing is required, these time periods disappear. Although there may be some required review under state securities law which could result in delay, this will often not be the case as a result of an available exemption.[18] In either event, the length of time before closing

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[14] Section 5 of the Securities Act of 1933, 15 U.S.C. § 77e; Sections 305, 306, 307 of the Trust Indenture Act of 1939, 15 U.S.C. §§ 77eee, 77fff, 77ggg; Section 14 of the Securities Exchange Act of 1934, as amended, 15 U.S.C. § 78n. See: §§ 5.02[1], [2], [4], 5.03 *infra*. This filing requirement may also necessitate the preparation of audited financial statements. See § 1.04[1][c][ii] *infra*.

[15] 15 U.S.C. §§ 18a(a) *et seq*. This will generally be the case in acquisitions of sufficient size, subject to certain exceptions. See § 5.04 *infra*. Similarly, if the acquisition is of a company in a regulated industry, the regulatory approval process can be lengthy. See § 5.05 *infra*.

[16] The major reason for the use of cash tender offers as a first or one of the first steps in consummating a friendly cash acquisition is the relatively short time it takes for the purchaser to acquire control of a publicly held company, as contrasted to the one step shareholder-approved merger route. See: Section 14(d), (e) of the Securities Exchange Act of 1934, as amended, and Regulations 14D, 14E thereunder, 15 U.S.C. § 78n(d), (e); 17 C.F.R. §§ 240.14d-1 *et seq*., §§ 240.14e-1 *et seq*.

[17] For certain types of transactions, for example, going private acquisitions, particularly where minority shareholders are receiving securities in a highly leveraged entity, or transactions involving complicated accounting issues or several different parts such as spin-offs, each of these periods, and particularly the SEC review process, could be lengthened by months. Alternatively, the periods can be much shorter, particularly for a "plain vanilla" transaction which the SEC determines not to review. Unfortunately, since the decision to review a document is solely within the SEC's discretion, a certain amount of "uneducated guessing" is unavoidable.

[18] The law of each state where a target shareholder resides must be considered. The available exemption will vary from state to state. Common exception include private placements, offers and sales of listed or "blue chip" securities and, in states which have adopted Section 401(j)(C) of the Uniform Securities Act, offers and sales which are incident to a class vote of shareholders on a merger. See § 14.05[4] *infra*.

will also depend on whether there is a shareholder vote required by state law,[19] and whether there are any state disclosure requirements in connection with such a vote.[19.1] There will be an additional waiting period under state corporate law if a vote is required by shareholders on a merger[20] or a sale of all or substantially all of a corporation's assets.[21] In certain limited instances, these statutory periods can be dispensed with.[22] Additional time periods might be imposed by the Securities Exchange Act of 1934, as amended,[23] the rules of a national securities exchange[24] or a party's certificate of incorporation or agreements with shareholders or institutional holders of convertible debt.[25]

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[19] There will also be a waiting period in the case of a registered third party exchange offer. See: Section 14(e) of the Securities Exchange Act of 1934, as amended, 15 U.S.C. § 78n(e), and Rule 14e-1 thereunder, 17 C.F.R. § 240.14e-1.

[19.1] See, e.g.: Lynch v. Vickers Energy Corp., 383 A.2d 278, 281 (Del. 1977); Dubroff v. Wren Holdings, LLC, 2009 WL 1478697 (Del. Ch. May 22, 2009) (involved a recapitalization); §§ 5.03[2], Ns. 46.1-46.4 *infra*, and accompanying text, 16.02[4], N.8-9.1, *infra*.

[20] See, e.g.:

California: Cal. Corp. Code § 601(a) (ten days; thirty days if sent by third class mail).

Delaware: 8 Del. Code Ann. § 251(c) (twenty days).

New York: N.Y. Bus. Corp. L. § 605(a) (ten days if sent by first class mail; twenty-four days if by third class mail).

See also: Model Bus. Corp. Act §§ 1.41(c), 7.05(a), 11.04(d) (Official Comment 2—Submission to the Shareholders) (1999) (ten days).

[21] See, e.g.:

California: Cal. Corp. Code § 601(a) (ten days; thirty days if sent by third class mail).

Delaware: 8 Del. Code Ann. § 271(a) (twenty days).

New York: N.Y. Bus. Corp. L. § 605(a) (ten days if sent by first class mail; twenty-four days if by third class mail).

See also: Model Bus. Corp. Act §§ 1.41(c), 7.05(a), 12.02(d) (1999) (ten days).

[22] Many states permit shareholders to act by written consent, without prior notice or a shareholder meeting unless prohibited by the company's certificate of incorporation. See, e.g., 8 Del. Code Ann. § 228. If the required vote is obtained in this manner, the merger can be consummated without the required wait referenced in Ns. 20, 21 *supra*. One exception to this, however, is where the company is subject to the SEC's proxy rules. In this case, an information statement which complies with Regulation 14C, 17 C.F.R. §§ 240. 14c-1 *et seq*., must be prepared and distributed to stockholders twenty days prior to the action being taken. See Rule 14c-2(b) under the Securities Exchange Act of 1934, as amended, 17 C.F.R. § 240.14c-2(b). The SEC's review authority with respect to information statements is essentially the same as proxy statements.

[23] See: Rule 14c-2(b) under the Securities Exchange Act of 1934, as amended, 17 C.F.R. § 240.14c-2(b) and General Instruction 2 to Form S-4 promulgated under the Securities Act of 1933, 17 C.F.R. § 239.25.

[24] See New York Stock Exchange Listed Company Manual ¶ 401.03 (thirty days between the record date and the shareholder meeting date recommended by the Exchange).

[25] This would most likely be the result of either a fair price/supermajority vote provision in a target company's certificate of incorporation that is triggered by the transaction, provisions in the terms of a preferred stock or the agreement pursuant to

At the end of the period, the shareholders meeting will be held and the vote taken. By contrast, if the transaction is a stock purchase, then, subject to the time necessary to allow shareholders to review any necessary disclosure document (if any)—a matter of contractual agreement and possibly federal securities law, but not generally state corporate law—no additional time is needed.

The second common determinant of the time from signing to closing is the Hart-Scott-Rodino Act. This Act, if applicable to the acquisition[26] will require a waiting period of 30 days (15 days in the case of a stock purchase by cash tender offer rather than a privately negotiated stock purchase, asset acquisition or merger)[27] from the filing of the requisite forms[28] before the transaction can be consummated. If the Federal Trade Commission or the Antitrust Division of the Department of Justice request additional information before the expiration of the waiting period, the period will be extended until 20 days (10 days in the case of a cash tender offer) following "substantial compliance" by the parties with the requests for additional information.[29] If the Federal Trade Commission or Department of Justice have concerns about the anti-competitive effects of the transaction, they will often ask the parties to voluntarily extend the waiting period beyond the statutory limits; failure to voluntarily extend the waiting period could result in the commencement of litigation by the applicable governmental agency.

[ii]—Other Timing Considerations: Regulated Industries and Financing Considerations

The need for governmental approvals in certain regulated industries can significantly increase the time required before closing. This is

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which it was issued or in a "standstill" or similar investment agreement with a substantial shareholder.

[26] See § 5.04 *infra*.

[27] Unless the waiting period is terminated early by the Federal Trade Commission or the Department of Justice. See Section (b)(2) of the Hart-Scott-Rodino Act, 15 U.S.C. § 18a(b)(2).

[28] The Notification and Report Forms cannot be filed until the parties have executed the acquisition agreement or letter of intent, the buyer has commenced a tender or exchange offer, or otherwise has an intention to acquire shares in the open market. See: Section (e) of the Hart-Scott-Rodino Act, 15 U.S.C. § 18a(e), and Rules 801.30 and 803.10 of the Federal Trade Commission thereunder, 16 C.F.R. §§ 801.30, 803.10, discussed at § 5.04 *infra*. The letter of intent alternative will commence the waiting period running earlier than the other possibilities and even could, depending upon the negotiation process and the antitrust review, result in the waiting period under the Hart-Scott-Rodino Act having terminated prior to the execution of the definitive acquisition agreement. This is one of the primary reasons why parties sometimes decide to enter into a letter of intent. The letter of intent need not be at all detailed to accomplish this result. See § 6.01 N. 6 *infra*, and accompanying text.

[29] See § 5.04 *infra*. In the case of a cash tender offer, "substantial compliance" by just the buyer will start the ten-day period.

particularly true with respect to acquisitions of companies in the broadcasting and cable,[30] aviation,[31] railroad,[32] banking,[33] insurance[34] and other regulated industries, as well as acquisitions of public utilities.[35] In certain cases, if the regulated business is not a major portion of the company being acquired, the buyer might be willing to deposit the stock of the subsidiary which conducts it in a voting trust pending receipt of regulatory approval.[36]

There are other events that might occur during this period in any particular transaction, some of which could significantly lengthen it. For example, if the purchaser has to obtain financing to consummate the acquisition,[37] the negotiation of loan terms and documentation will usually occur during this period, although the process will, in all likelihood, have been commenced prior to the signing of the acquisition agreement.[38] If any third party consents or waivers are required in connection with the transaction, this is the time when they will generally be obtained. In addition, if a tax ruling is a condition to either party's obligations to close,[39] the ruling request will be filed during the early part of this period.

Finally, the period of time necessary between signing and closing may be significantly affected by the pre-signing status of financial statements of the business being acquired. If the statements are unaudited, the buyer or its financing source may well demand that an audit be performed prior to closing, sometimes accompanied by a physical inventory. This is particularly true if the business being acquired is a subsidiary of the seller because there may be significant questions concerning inter-company transactions or if all or some portion of the purchase price has been negotiated by reference to a specific balance sheet or earnings test. For this purpose, however, some procedure less than a full-blown audit may be acceptable to the parties. The matter is further complicated if the buyer's financing is to be obtained in the public market because the SEC's accounting rules may then require

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[30] See § 5.05[2] *infra*.

[31] See § 5.05[3] *infra*.

[32] See § 5.05[4] *infra*.

[33] See generally: the Bank Holding Company Act of 1956, as amended, 12 U.S.C. §§ 1841 *et seq*.; the Change of Bank Control Act of 1978, as amended, 12 U.S.C. §§ 1817(j); the Bank Merger Act, 12 U.S.C. § 1828(c).

[34] See § 5.05[8] *infra*.

[35] See § 5.05[5] *infra*.

[36] Not all regulatory agencies would permit this solution.

[37] See Chapter 20 *infra*.

[38] *Id*.

[39] See § 14.07 *infra*.

as much as three years of historical audited financial statements.[40] Whatever the outcome in a specific transaction, due to the timing constraints involved, the parties are well served early in the transaction to consider and agree upon the state of financial statement preparation and examination that they will find acceptable.

Between signing and closing, the company being acquired will continue to be operated, subject to the provisions of the acquisition agreement,[41] by its existing management. It will be a critical aspect of the negotiations, particularly in acquisitions of non-public companies, whether the business is being run during this time period for the benefit of the buyer or the seller. A fixed purchase price would generally mean that it is for the benefit of the purchaser; a variable price, such as one employing a closing book value adjustment, would usually mean the opposite.[42]

[d]—The Closing

The next, and, in many cases (insofar as the attorneys are concerned), final, event is the closing. At the closing the buyer will purchase the selling shareholders' stock (in a stock purchase transaction), the selling company's assets (in an asset purchase transaction) or effect the merger (in a merger transaction). Whatever documents of transfer are needed (in the first two cases) or are to be filed in the appropriate secretary of state's office (in the merger situation) to accomplish the transaction will be delivered or filed at closing, as well as any officers' certificates,[43] opinions of counsel,[44] and accountants' letters[45] required by the acquisition agreement. Any material third party consents will be made available at closing for the buyer to inspect.

The closing will usually occur as soon as possible. In many transactions, this will mean as soon as practicable after the expiration of the Hart-Scott-Rodino Act waiting period, and the obtaining of all requisite shareholder and regulatory approvals. The closing might get delayed, however, in order to resolve any pending litigation (including deal related litigation), obtain third party or governmental consents or

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[40] See Rule 3.02(a) of Regulation S-X, 17 C.F.R. § 210.3-02(a).

[41] See Chapter 13 *infra*.

[42] See § 1.07 *infra* which includes a discussion of the effect of a business' seasonality on a purchase price adjustment mechanism.

[43] See § 14.02[5] *infra*. There will often also be a certificate of the secretary of each party certifying as to, among other things, the accuracy of board and shareholder resolutions and bylaws.

[44] See: §§ 14.07, 14.09 *infra*.

[45] See § 14.06 *infra*.

for any other reason negotiated by the parties. It is important for those provisions to be drafted carefully. For example, does the failure of the bringdown condition to be satisfied at the scheduled closing result in the closing being postponed (possibly until a pre-determined outside date) or in the transaction being terminated? What about a delayed closing by virtue of the failure to obtain a material third party consent? Moreover, if the answer is that the closing is postponed in these situations, then for how long? Often, there is an agreed upon outside termination date on which either party can terminate, at least if its breach is not the cause for the closing not to have theretofore occurred. What happens, however, if there is no such date?[45.1]

Following the closing, a press release will be issued in many transactions.[46]

[e]—Post-Closing

From the attorneys' point of view, the major items which remain after the closing are, if the agreement so provided, indemnification claims,[47] price adjustments based on a closing balance sheet[48] and perhaps the provision of transition services by the seller post-closing.[49] Of course, from a business point of view, now is when the real work begins: integrating the different businesses and management structures with each other.

[2]—Deferred or Simultaneous Closings

It is sometimes possible to dispense with the period between signing and closing. This can only occur if the parties are willing to delay the signing of the agreement until they are otherwise willing to close and if they are legally able to do this. There are several reasons why this might not be possible. As noted above, before the Hart-Scott-Rodino Act Notification and Report Forms can be filed and the waiting period commenced in a non-tender offer situation, either the acquisition agreement or a letter of intent must be executed. Thus, if the transaction is subject to the Hart-Scott-Rodino Act, and the parties do not sign a letter of intent, there will have to be a period between the execution

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[45.1] See Henkel Corp. v. Innovative Brands Holdings, 2008 WL 4131566 (Del. Ch. Aug. 26, 2008) (court determined, in the absence of a termination date, that it would keep contract alive for a "reasonable time").

[46] This will certainly be the case if the acquired business was publicly held or a material subsidiary or division of a public company. See Chapter 7 *infra*.

[47] See Chapter 15 *infra*. Other matters might include honoring any registration rights and transferring ERISA plan assets. See: §§ 13.04[2], 19.03 *infra*.

[48] See § 17.02 *infra*.

[49] See § 18.05 *infra*.

of the acquisition agreement and the closing thereof, in order to allow the waiting period to run. In addition, if shareholder approval is required in the case of a merger or sale of assets, many state corporate statutes require that the acquisition agreement be signed before being submitted to shareholders for their vote.[50] As a consequence, simultaneous signings and closings occur most often in purchases of subsidiaries, divisions and private companies where a letter of intent has already been entered into.

The parties may have differing interests in delaying the execution of the acquisition agreement until they are ready to close. One obvious consequence of such a delay is that the parties will not be contractually bound to the transaction until they are ready to close. This will oftentimes benefit one party more than the other,[51] if for no other reason than simply because there may be a greater likelihood that some event will occur prior to signing that could cause that party, rather than the other, to want not to close.

A potential consequence of the decision to have a simultaneous signing and closing is a simplified acquisition agreement. For example, there is no need for the portions of the agreement dealing with the period between signing and closing, the "covenants article"[52] including the conduct of the parties' businesses during this period, since it does not exist. Moreover, there is no need for conditions to the parties' obligations to consummate the transaction[53] since the act of signing in effect constitutes the closing as well. Having said all this, even if there is not to be a deferred closing, the parties often negotiate an agreement that reads as if there is. After all, insofar as the conditions are concerned, the parties are going to have to be in agreement as to what has to happen before they sign: what third party and governmental consents are needed; what opinions and certificates are to be delivered; and what litigation will cause a problem. Negotiating these provisions in the agreement is as good a method as any to come to terms on these matters, even if it essentially serves as only a checklist. The parties, of course, will not be bound until they sign (are ready to close).[54]

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[50] Even apart from this requirement, it never (or almost never) occurs that the parties will delay signing an acquisition agreement for a public company until the closing.

[51] One party (for example, the purchaser if it has a financing condition) may not be particularly (legally) committed to the transaction even if the agreement had been signed whereas a seller may in fact be bound if the agreement had been signed. See § 20.04 *infra*.

[52] See Chapter 13 *infra*.

[53] See Chapter 14 *infra*.

[54] This procedure has the additional benefit that the parties can change their minds and switch to a deferred closing if something occurs to cause them to want to do so.

§ 1.05 The Acquisition Agreement

In most acquisitions, the acquisition agreement is the cornerstone of the transaction. Once executed,[1] with rare exceptions,[2] the acquisition agreement alone will determine the parties' behavior prior to closing and their rights, obligations and remedies vis-à-vis each other.

With the exception of the first portion of the agreement, which will generally set forth the basic economics and form of the transaction and certain obvious differences resulting from the identity of the parties, acquisition agreements are generally very similar in structure regardless of whether they are for an asset purchase, a stock purchase or a merger.

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[1] One cautionary note to keep in mind is that it is possible that a contract may become binding and enforceable *prior* to the final execution of a definitive agreement. See, e.g., AIH Acquisition Corp. v. Alaska Industrial Hardware, 2003 WL 21511921 (S.D.N.Y. 2003). In *AIH Acquisition Corp.*, a stock purchase agreement was circulated for execution under the note, "everyone, including the lawyers, has stated it is final without qualification." When one of the parties refused to execute the agreement, a suit was filed, and the court found that the execution of the agreement was but a "formality" and held that the allegations supported the claim for specific performance of the stock purchase agreement. See also, R.G. Group. Inc. v. Horn & Hardart Co., 751 F.2d 69, 74 (2d Cir. 1984) ("where there is no understanding that an agreement should not be binding until reduced to writing and formally executed, and where all the substantial terms of a contract have been agreed on, and there is nothing left for future settlement, then an informal agreement can be binding even though the parties contemplate memorializing their contract in a formal document"). (Quotations omitted.) In order to avoid such an issue, deal lawyers should include specific language in drafts of acquisition agreements or letters of intent stating that it is the intent of the parties not be legally bound until a definitive agreement is executed. For a further discussion of letters of intent, see Chapter 6 *infra*.

[2] This is generally accomplished by use of a "merger clause" in the agreement; this is generally effective although in litigation matters outside "the four corners" of the document may well be admitted into evidence. The question is further complicated if other agreements are negotiated and executed by the parties (for example, agreements pertaining to specific topics such as a tax-sharing agreement or a non-compete agreement). If the agreement itself does not properly reflect the intention of the parties due to a drafting error, the underlying intention of the parties, and not the express language of the agreement, could, subject to parol evidence rule considerations, govern. See, e.g., Cerberus International, Ltd. v. Apollo Management, L.P., 794 A.2d 1141 (Del. 2002). In *Cerberus*, initial correspondence between the target and acquiror indicated that the exercise of certain outstanding warrants and stock options would be paid to the acquiror's shareholders in addition to the negotiated purchase price; the finalized merger agreement, however, provided that the stockholders were to receive the purchase price *minus* the proceeds of the options and warrants. The Delaware Supreme Court ruled that reformation of an unambiguous contract was appropriate only in cases of either (1) mutual mistake or (2) unilateral mistake with respect to a material term if the other party remains silent even though it is aware that the first party is mistaken. The case was remanded to determine whether, as a factual matter, either occurred. See *id*.

In the case of asset and stock purchase agreements, the sellers (the target in the case of an asset sale and stockholders in the case of a stock sale) will be signatories to the agreement, and will be the party or parties doing the selling. In the case of stock sale, the target may also be a party to the agreement so as to enable the buyer to impose obligators (such as the covenants described below) directly on the target, rather than relying on the selling stockholders having agreed "to cause the target" to comply with such obligations. Conversely, in merger agreements the target shareholders are not a party to the agreement, and their "sale" occurs statutorily by operation of the applicable merger statute. In the situation where the target stockholders, or some of them, are not parties to the merger agreement, the question arises as to how various provisions such as indemnification provisions[2.1] or post-closing purchase price adjustments[2.2] are binding upon non-signing target stockholders. The answer may well depend on the language and interpretation of the applicable state merger statute.[2.3]

[1]—The "Deal" Provisions

There is no standard name for the introductory sections of the agreement and those provisions that state what the transaction actually is: What is being acquired? Whose stock? Which assets? Which liabilities are being assumed? What is the purchase price? If cash, is it payable in same day funds? If it is in the form of securities, how many and with what terms? Which company is merging into which and what happens in the merger to the stock of these companies? How will shareholders exchange their shares for the purchase price? What will happen to outstanding employee stock options? Is there a purchase price adjustment?

These provisions, which can be the most important in the entire agreement, may be simple, as will usually be the case in a simple stock purchase agreement for a fixed cash amount, or very complicated, as would occur, for example, in a cash election merger,[3] or a transaction where there was an earn-out[4] or a closing balance sheet adjustment.[5]

[2.1] See: § 1.05[5], *infra*, Chapter 15, *infra*.

[2.2] See: § 1.05[1], *infra*, Chapter 17, *infra*.

[2.3] See: Aveta, Inc. v. Cavallieri, 23 A.3d 157 (Del. Ch. 2010), discussed at § 15.05 [2], N. 5, *infra*; § 17.02 N. 1, *infra*.

[3] See § 22.03 *infra*.

[4] See § 17.03 *infra*.

[5] See § 17.02 *infra*.

[2]—Representations and Warranties

Each party to the agreement makes representations concerning its business and the effect of the transaction on it. Specifically, on the "sell side" of the transaction, the "selling" company, selling its assets or being acquired in a merger, will make the representations in an asset transaction or a merger; the selling shareholders will usually make the representations in a stock sale. The buyer's representations may (and in a cash acquisition almost certainly will) be much less extensive than those of the sellers.

As discussed more fully elsewhere,[6] representations and warranties are statements made by a party about itself or the company it owns. The representations in effect paint a picture of such party as of the date of the agreement or, in the case of certain representations, other specified dates. Representations can cover such matters as the due incorporation of a party; its qualifications to conduct business; its having authorized the transaction; receipt of any regulatory approvals or third party consents it must obtain prior to consummation; compliance with generally accepted accounting principles of its financial statements; the absence of material adverse changes in its business and many other matters.

(Text continued on page 1-41)

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[6] See: Chapters 11 and 12 *infra*.

If a representation is false when made, that is, when the agreement is executed, the representing party may be liable for damages whether or not the transaction closes. If a representation becomes false by the time of the closing, the other party will generally be allowed to refuse to close. This is the critical "bringdown" condition. If the representation is false at closing, and this is not disclosed to the other party and the acquisition is consummated, the other party might be entitled to indemnification for losses or damages as a result.

[3]—Covenants

Whereas the representations are descriptive statements about a party's business at a point in time, the covenants are agreements by the parties about actions they agree to take, or refrain from taking, between signing and closing (or, occasionally, thereafter).[7]

Covenants are generally of three types. The first relates to the conduct of the seller's (and, in a noncash acquisition, the purchaser's) business. The parties generally agree, for example, to conduct their business in the ordinary course. Some agreements impose no other limitations than this; others continue for several pages with a detailed list of exactly what can and cannot be done. The second type of covenant relates to activities which the parties must take to consummate the transaction: to file documents with governmental agencies, to try to obtain third party consents, and to allow the other party access to its business. The final set of covenants relates to the parties' obligations when third parties attempt to intervene, for example, make a competing bid for the target.[8]

[4]—Conditions

The conditions[9] determine whether a party has to go forward and consummate the transaction. Thus, for example, the buyer may have agreed to purchase the selling shareholders' stock or the target's assets, but if the conditions to this obligation of the buyer are not satisfied, it need not consummate the purchase; it can, without risk of liability, refuse to consummate the acquisition. As noted above, one critical condition almost always found is that the other party's representations and warranties be true at closing.[10] If this is not the case, the party need not close. Other conditions may include receipt of any necessary shareholder approvals; delivery of opinions of opposing

[7] See Chapter 13 *infra*.
[8] See § 13.05[1] *infra*.
[9] See Chapter 14 *infra*.
[10] See § 14.02 *infra*.

counsel as to various matters; receipt of a tax ruling or opinions; receipt of accountants' letters; obtaining of third party and governmental consents and approvals; availability of financing; absence of litigation; and, in noncash transactions, conditions relating to securities and stock exchange matters.

[5]—Indemnification

Many agreements for the acquisition of private companies, subsidiaries and divisions will provide for indemnification.[11] These provisions grant either party (particularly, the purchaser) the right to recover, post-closing, for misrepresentations and non-compliance with covenants by the other party. Because these provisions have real economic substance, they are among the most hotly negotiated aspects of the agreement.[12]

[6]—Miscellaneous Matters: Choice of Law; Consent to Jurisdiction; Termination; Fees

The "back" portions of acquisition agreements often deal with a number of miscellaneous items including choice of law, consent to jurisdiction, termination rights and effect of termination. It would be a mistake for the attorneys to view these provisions as mere boilerplate and not pay close attention to them. Imagine, for example, the effect of a provision which stated that a party's sole remedy in the event of a breach by the other party was to terminate the agreement.

One relatively recent development that grew out of leveraged buyout transactions is the inclusion of "bust-up" fee and expense reimbursement provisions in acquisition agreements.[13] While such provisions are less common in transactions where the buyer is itself an operating company, rather than an LBO boutique or merchant banking firm, they are appearing in such situations with increasing frequency.

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[11] It is highly unusual, but not unheard of, for indemnification to be available in connection with acquisitions of public companies. See § 16.04 *infra*.

[12] See Chapter 15 *infra*. Since the right to indemnification often derives from the existence of a misrepresentation, the presence of indemnification rights will result in much greater attention being paid to the representations, particularly those of the seller, made in the acquisition agreement.

[13] See § 20.04 *infra*.

§ 1.06 Interplay between Representations and Warranties and Due Diligence

It is important for lawyers to bear in mind that an acquisition transaction is an interactive process in which the acquisition agreement serves as both a template which reflects matters which are of significance to the parties and as a "road map" of how the parties get from deal concept to consummation.

The "road map" function is straightforward and is referred to often in these chapters: for example, the covenants in the acquisition agreement will generally restrict the business activities of the business being acquired between signing and closing as well as require the buyer and seller to make the necessary governmental filings and obtain the necessary third party and governmental approvals during that period. What is less obvious, however, is the interplay between the due diligence performed by the buyer (and sometimes the seller or sellers) and the representations and warranties in the agreement upon which such party relies.

That process goes both ways: a party may well ask for a specific representation and warranty on a certain topic because its investigation of the business being acquired has convinced it that such topic is particularly important to that business or has made it aware of a specific problem or concern as to which it wants the added comfort of a specific representation. The scope of a buyer's due diligence may also (unwittingly, perhaps) form the basis for the "definition" of materiality in the representations. For example, if the seller wishes to limit its representation as to contracts by providing that it is being made as to contracts for sales in excess of a certain dollar volume, the dollar amount chosen by the parties may well mirror the dollar amount reflected in the agreements which the buyer has examined in its due diligence process.

That points up another issue, which is the importance of the lawyer negotiating the acquisition agreement making sure that the diligence function being performed fits well with the representations and warranties in the agreement being drafted. In the contract representation example, it may be of less value to a buyer to have a post-closing claim for indemnification against the seller for a problem with a contract providing for sales of greater than the agreed upon amount than to have had the ability not to consummate the transaction if it had seen all the contracts fitting that criterion and its due diligence examination had revealed the problem. Thus, it is critical for the lawyers negotiating and drafting the agreement to keep apprised of the specifics of the due diligence examination being conducted and to keep looking for, and close, "holes" of this sort.

§ 1.07 The Purchase Price: Cash v. Noncash; Adjustment Mechanisms and the Effect of Seasonality

The form the purchase price takes will have a significant effect on both the acquisition process and the form of the acquisition agreement. Noncash consideration will render it important for the seller to conduct a due diligence examination of the buyer's business and, perhaps, seek extensive representations and warranties concerning the buyer and related post-closing indemnification rights. If the buyer and seller are similar-sized entities, and the purchase price is in the form of common stock, it may well force the buyer and seller to view the transaction not as a purchase and sale but as a "merger of equals" that requires both of their managements, directors and stockholders to consider and agree upon the role each will play after the closing in the management and direction of the new combined entity.[1] In the proper circumstance, particularly for a business whose potential is not yet fully realized or one in which the value in the hands of a different owner is unclear, the parties may want to negotiate an "earn-out."[2] This is a purchase price which is paid over time to the seller based upon the acquired company's post-closing performance.

The time needed between signing and closing will also be affected by a noncash purchase price if the securities constituting the consideration need to be issued to the sellers pursuant to an effective registration statement under the Securities Act. Extra time may also be required to perform related filings such as under various stock exchange regulations, "blue sky" laws or the Trust Indenture Act.

None of these factors are present in a "cash" deal. In a cash transaction the sellers need only worry and examine whether the buyer is sufficiently well-capitalized or financed to consummate the transaction and perform its obligations set forth in the acquisition agreement. While it is possible that some members of the target's management may be asked to continue to play a management role with the combined entity, in a cash transaction the negotiation of these matters does not focus on the protection of the value of the consideration being received in the deal but, rather, takes on the indicia of an employer/employee relationship, recognizing, of course, that the employee in question may in fact have received a good deal of cash in the transaction in question.

If the purchase price is fixed at signing, rather than varying until closing based upon some agreed-upon factor, the target's business is

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[1] See: §§ 1.08, 22.01 *infra*.
[2] See § 17.03 *infra*.

essentially "sold" at the time of signing with the business being run for the benefit (or detriment) of the buyer post-signing but preclosing even though it may continue to be operated by the target's management operating only under the constraint of the operating covenants set forth in the acquisition agreement.

While this happens in a number of public company acquisitions,[3] it is more often the case in acquisitions of subsidiaries, divisions and private companies that the target's business is valued and the purchase price set or adjusted at closing. Because the exercise of setting this price often requires the preparation of, and agreement to, financial statements or financial tests, the accounting process and the adjustment itself often take place post-closing. The range of types of adjustments includes working capital adjustments, book value adjustments and earnings tests.[4]

If the target's business is seasonal in nature, the parties will need to carefully consider the time of signing and the time period between signing and closing in their consideration of, and agreement to, a purchase price. For example, a retail business incurs a tremendous "run-up" in working capital in the fall season in preparation for its holiday selling season. If the acquisition agreement is signed in July and the transaction closes in October, the target will essentially be run for the benefit of the buyer post-signing unless there is an adjustment in the purchase price to reflect increased inventory spending by the target during this period. This is probably so even though in theory (for example, assuming complete saleability of inventory) no adjustment should be needed because the target's cash has merely been replaced by inventory. This is more of a problem in a business where seasonal needs require that some or all of the inventory purchasing must be funded by a corporate parent. In that case, without a postclosing adjustment, the fact that the seller may be entitled to the target's earnings during this period may not be sufficient to solve the problem, since a seller may well be satisfied with slightly lower earnings for the period but the buyer (and the target) may be seriously damaged in a competitive sense by a lack of inventory and a poor holiday selling season. This is even more true when you consider the "lag time"—goods purchased before October may well not be sold in the ordinary course of business until November or December and then the buyer

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[3] A significant number of public company common stock acquisitions, however, are priced, not by use of a fixed exchange ratio, but, rather, based on the trading prices of the acquiror's stock for a fixed period prior to the target shareholders' meeting to vote on the transaction. See § 16.05 *infra*.

[4] See § 17.02 *infra*.

will fall heir to lower earnings (because of low levels of inventory) in this period.

In the proper circumstance, of course, this fact pattern may be reversed, with the business run for, and its earnings accruing to the benefit of, the buyer once the agreement is signed. Either method requires careful thought and well-developed purchase price adjustment mechanisms and signing-to-closing accounting controls and covenants to "keep everyone honest."

Finally, over and above the effect of seasonality on a purchase price adjustment and the target's business during the period between signing and closing is its effect on the basic valuation of the target and the appropriate purchase price. Clearly, if the purchase price is to be determined by reference to a method employing some multiple of the target's earnings or a discounted cash flow analysis, the raw data used in that calculation will need to be for a period of time (for example, the preceding twelve-month period) that will not be skewed by the seasonality of the target's business.

§ 1.08 Social Issues

"Social issues" affect almost every transaction although in a tremendously varying manner. These questions focus upon the status and compensation of individuals and their relationship to the transaction and to the post-closing entity. In the transaction, how will target stock options be treated? Will their vesting be accelerated or will they be "cashed-out"? What will be the effect on this if the purchaser wishes to retain some or all of the target's officers in the management of the target post-closing? Indeed, are some of these employees so important as to result in the buyer making the negotiation of employment agreements with them a condition to closing? Generally, will the purchaser retain the work force and continue their pre-existing compensation and benefits packages? Other related issues involve such things as whether the buyer will agree not to physically relocate a division or, more commonly, headquarters of the acquired company. Another very important "people" issue has to do with the question of to whom will target management report following the closing.

An additional series of questions are presented if the target had a "founder" or a "founding family" among the selling stockholders. How important is that person's expertise or reputation to the continued success of the company? Will the founder agree to a sale of "his baby" at all without some promise of continued involvement such as a consultancy or a seat on the post-closing board of directors? Indeed, can the target continue to thrive if the founder leaves? Will his former employees be demoralized by what they might view as his "selling out"?

None of these questions are straightforward and the answers will vary depending upon the situation. The cost of any of these choices can sometimes be somewhat hidden (for example, severance costs) but are no less real. Primarily, it will be important for the purchaser to consider how it wants the company to operate post-closing and then consider the effect, both on the company and on the likelihood of obtaining the seller's agreement to the transaction, of proceeding in this manner. While many of these issues are of a business rather than legal nature, it is foolhardy for a lawyer to ignore them because they determine in large part the spirit of every transaction.